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Diplomová práce

2006 **Irina Skorokhodova**

UNIVERSITAS CAROLINA PRAGENSIS

Charles University in Prague

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INTERNATIONAL ECONOMIC AND POLITICAL STUDIES

MASTER THESIS

"On the nature of the divergent economic outcomes during the post-Socialist transition"

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Academic year: 2005/2006

Prohlašuji, že jsem diplomovou práci vypracovala samostatně a použila pouze uvedené prameny a literaturu.

I do hereby declare that I have written this thesis independently and that I have used only the sources listed.

Prague, 22nd May 2006

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Acknowledgements:

I would like to thank my supervisor, Doc. Ing. Tomáš Cahlík, CSc. of the Faculty of Social Sciences, Charles University for the useful comments and suggestions throughout the whole time of the diploma development. Furthermore, I want to thank my family members for their support and especially my father for the constructive critics. Special thanks to my bridegroom Mykhaylo for an extraordinary patience.

ABSTRACT

The focus of this thesis is to introduce the reader with the recent developments in the countries in transition from the centrally-planned economy towards a "healthy" democratic system with free market relations. The main aim is to analyze the divergence of paths the countries have experienced in the course of transition, particularly, the rapid recession and a following recovery, since it is critical for any country already experiencing the transition (from any system "A" towards any system "B") or just preparing itself for the process. The comparative analysis in the form of case-by-case and point-by-point methods dominates in the research. The work tries to answer two basic questions: "Why had the post-Socialist countries in transition face a serious output decrease and, generally, an economic recession?" and "Why the developments were divergent throughout the region?" The existence of output recession is proved with the help of several economic indicators, such as evolution of GDP, inflation rate, registered unemployment rate, Human Development Index, composition of GDP by sector, but also GINI coefficient and poverty ratio, etc. Initial conditions index, Transition progress indicator, Liberalization index, Index of institutional quality, etc. support the second part of the thesis. In search for reasons for divergent development progress, the dominant role of the initial conditions and transition strategies is undisputable. The comprehensive approach allows seeing the situation with the most accuracy. However, they still have gaps in explanatory power, so the alternative parsimonious approach by Havrylyshyn (2006), called 'Transition Navigation Model' is added to identify the most crucial factors that determine the performance during the transition. It focuses on the effects of the delay in the reforms leading to proclivity to rent-seeking, state capture, and a frozen transition on the one hand; in contrast to the "EU beacon" stimulating the catch-up and preventing the state capture by powerful oligarchs on the other hand. The variables are combined and the nature of the divergence is identified.

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Introduction

15 years have passed since the collapse of the Soviet Union. Throughout this period the economies of the former Eastern block have experienced a painful transition from a socialist-type planned economy to democracy and market economy, and in several cases the transition has surely not finished. The significance of the fundamental change of the system can not be underestimated. Aslund (2002) made an impressive statement: "...This was an extraordinary event... A complete ideological, political, economic, and social system just passed away, and a large part of the world with some 400 million inhabitants was to choose new shape in every regard, including what countries they should divide themselves into...This was one of the greatest revolutions the world has seen..."[1]

The massive economic recession that followed after the breakup of the system was not surprising to the majority of specialists on transitology. The U-shape scenario of economic performance the countries experienced by the countries was explained in numerous studies: all economies went through a slowdown of economic growth in the early stage of the transition and the recovery tendency became visible only later (in terms of economic indicators). Even though numbers varied, the trend was common throughout the region. Another common trend throughout the region was that some countries are recovering more dynamically than others. It became really visible already in 1993-1994, when CEE countries started to grow (in terms of GDP per capita in PPP for example), while others (mainly CIS countries) continued to decline further. On the other hand, there was a reversed performance in terms of unemployment. Here, again the countries of the Central Europe were more successful in combating the negative effects on the population, than the countries of CIS and partly the South-Eastern Europe (due to war conflict). Not only the high unemployment, but visible social inequality and rather high poverty level are common in these countries, and it seems that the situation will not change significantly in the near future (except the former Yugoslavia region, which tends to develop more like a CEE group of countries). After the decade of reforms it is possible to make a conclusion that there is a serious delay in the economic recovery in the CIS countries in comparison to Central Europe, Baltic States, and South-Eastern Europe.

Whereas the economic recovery in the Central Europe, Baltic States, and partly South Eastern Europe was dynamic in its nature (as reflected in the level of economic performance); CIS countries seem to lag behind in their economic growth. In search for reasons for divergent outcomes not only the initial conditions and transition strategies of countries should be considered, but also other factors, specifically the alternative approach by Havrylyshyn (2006),

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[1] Aslund, A. (2002) pp. 1

which focuses on the effects of the delay in the reforms leading to proclivity to rent-seeking, state capture, and a frozen transition on the one hand; and "EU beacon" stimulating the catch-up and preventing the state capture by powerful oligarchs on the other hand.

The work will try to answer two basic questions: "Why had the post-Socialist countries in transition face a serious output decrease and, generally, an economic recession?" and "Why the developments were divergent throughout the region?"

The first part of the paper will present the theoretical and empirical considerations of the economic transition process and its major weakness – overall recession. Chapter I will shortly discover the rise of transitology as a field of the economic science. Then, the position of the research topic will be determined through the analysis of the modern transitional debates. Chapter II will focus on transitional recession in general, will summarize its extent in six different economies within the post-Socialist area using the empirical indicators given by various sources, and will try to explain the reasons for such developments (as described by influential economists dealing with the topic, both western and local). The second part of the work will analyze the difference in growth performance and the prospects for future developments. Chapter 3 will focus on divergent outcomes and will be based on the theories dealing with the impact of initial conditions, the role of the structural reforms undertaken (central assumptions in Aukucionek (1995), Havrylyshyn (2006), Aslund (2002), etc.), the role of the statistical error (Lavigne (1999), etc.). Chapter 4 will sum up the situation and discover the possible scenarios of the future developments trying to answer the question if such regional disparities would preserve in near future.

Purpose of the work

The economic and social cost of transformation in the post-soviet economies is a highly disputable topic in modern transitology. The debate in the scientific world extends over many controversial issues, including the unexpectedly large fall of industrial output, rise in unemployment, and an overall economic recession in the countries of the former Eastern Block. The recession by itself is not that most frequently discussed topic, since significant evidence was generated by national and international statistical institutions. However, there are serious divergences in the opinions of experts on the reasons for difference in growth performance between Baltics, Central Europe, and South-Eastern Europe on the one hand and CIS countries on the other hand. Consequently, the main aims of the work will be to test the dominant assumptions on the transition recession and analyze the differences in growth performance in six post-soviet economies using the empirical results and modern transitional theories.

Understanding the nature of the divergency in performance is critical for the future developments not only in the whole region, but worldwide as well. It can serve different countries in different manners: it can help the countries that are more successful in the transition to highlight their weaknesses on the way to real convergence with the EU level of economic development; and it can navigate less successful transition economies in their strategies for economic growth. Moreover, the analysis can be useful for any country in the world already experiencing the transformation of centrally planned economy (and, generally, from any "Model A" to "Model B") or only preparing itself for this process.

Methodology

The most weight will be naturally given to the economic side of the transition: economic policies, statistics, results, action plans, and debates between economists. However, the analysis from political scientists and historians would be added when appropriate to present the multi-perspective evaluation of the event. Basically, the role of these factors should not be underestimated. According to Havrylyshyn (2006), "...Any analysis that ignores the political economy of this process [transition] will surely miss the most powerful forces and explanations of the outcomes".[2] The comparative analysis is the main method used in the thesis. The first part of the paper discovers the roots of the transitional recession in general. For this matter the case-by-case comparison is applied, meaning that the performance of every country is discussed apart, pointing to individual specifics. The second part of the research concentrates on the differences in economic outcomes between the countries, so there is a need to classify and evaluate the dynamics of the transformation. Point-by-point comparison in this sense gives the reasonable outlook on the differences between countries (if the development is analyzed from several critical angles).

The rationale behind the analysis (grounds for comparison) lets know why the choice of time frame, countries, and appropriate indicators of macroeconomic development is deliberate and meaningful, not random. The time frame here is chosen to cover the period from the breakup of the centrally-planned economy until the present days. The year of the transition start varied throughout the region (1990 for Hungary and Poland, 1991 for Czech Republic, 1992 for Russia, 1993 for Croatia, and countries like Belarus not having started the serious reform yet, etc.), so the time frame for the work is chosen to cover the period of 15 years, from the year of the official dissolution of the USSR (1991) until the present days (2004-2005).[3] The year of the official collapse of the USSR was crucial in the economic sense, since all the socialist structures

[2] Havrylyshyn, O. (2006) pp. 6
[3] Depending on statistics available

and mutual economic cooperation had suddenly disappeared, leaving the states in a deep economic vacuum. The period is not that long; however, it allows analyzing the effect of policies of the individual countries in detail.

In order to cover the whole region (have the full picture) the developments in more that 20 countries should be analyzed. Since the central aim of the paper is to analyze the divergency in transition scenarios that have appeared, it would anyway require a detailed analysis of the major specifics of any country. Each state would be a specific case in terms of initial structural conditions, reforms undertaken, and the recovery outcomes. This analysis will focus on six countries that can reflect more or less the diversity of situations throughout the region. The countries are Czech Republic, Croatia, Estonia, Kazakhstan, Russia, and Belarus.

The choice of countries is determined by the combination of two different frameworks. First, the region of interest can be defined as the former Eastern block – USSR and its allies in the Central and Eastern Europe – today comprised of numerous economies in transition from the socialist and planned system towards capitalism and free market relations. Since there are many countries in the world experiencing economic transformation, the post-socialist model can be specified further. Krasnikova (2005) has summarized the distinct points. The post-socialist transformation had no analogue in history. The rapid collapse of system was not expected to come so soon even by the pro-Western Soviet observers, thus the new emerged states did not have own transition strategies prepared. As a result they accepted the policy advice from the West that was not actually designed specifically for them. Then, the reforms were initiated by the leaders of Socialist states, so the transformations were planned from above and thus they were deliberate. Besides, at the moment of crash of the Socialist system the industrial stage of development was already experienced in the majority of countries. At the same time, the legacy to the past can be a valuable obstacle to all the countries in the region, even though there are factors allowing growing to post-industrial level.[4] It should be mentioned that countries of the former Yugoslavia went through economic transformation too, even though it did not belong to the Eastern Block. Throughout the process, they followed the tendencies of post-socialist countries, implied similar policies, and went through similar problems (however, to a different degree). For the matter of this research the development in the Southern East Europe can also be relevant.

Secondly, the classification of Havrylyshyn (2006) used to compare the variance in outcome for different types of reform strategies can be useful when selecting the representative countries too.[5] There are five main reform strategies the countries experienced. The first type

[4] Krasnikova, E. (2005) pp. 22-25
[5] Havrylyshyn, O. (2006) pp. 159

[Advanced Start, Steady Progress] is represented by Croatia. Even though this country from the South-East Europe was rather late in the start of transition due to war, the later development was rather stable: it was more advanced in the early reform, but did not move that quickly. Czech Republic and Estonia represent the second type of strategy [Sustained Big-Bang]. Both countries started earlier and with a more rapid pace and were quick to recover their economies. Basically, the direction towards European integration produced less severe recession and thus a faster recovery. However, the initial conditions differed seriously between Czech Republic and Estonia. The time spent under planned economy and the severity of influence of socialism in the structure of economies was different. In this sense it is interesting to analyze both of them. Russia is chosen to represent the third type of reform strategy [Big-Bang Unsustained], where the reforms started rather early and moved fast but did not sustain the pace and so should be considered as aborted big-bang cases. Russia differs significantly from the previous type of strategy in the extent of change in the first years and, most importantly, in not sustaining this strategy but experiencing policy reversals and resurgence of inflation. Russian case is also interesting due to its size and country specifics. The renewal of the reform moved Russia towards positive and stable growth, but it still counts for the worst results in terms of macroeconomic indicators among other 5 countries. The next type of strategy [Gradual, Delayed Reforms] is represented by Kazakhstan. It is the biggest country in the Central Asian region; its economy is performing better that many other economies in the CIS, even though it participated in the planned economy as long and as intensively as other republics of the former Union. The start of reforms was seriously delayed or put on a very slow-track as a result of the extended fragility of democratic commitment. The answer here is in the combination of richness in natural resources and the Asian mentality. Finally, Belarus represents the fifth type of transformation strategy [Limited or Reversed Reforms], where the modest early progress was similar to many gradual reformers, but later it was haltered and indeed reversed. In the case of Belarus the political regime do not allow the degree of de-centralization and structural change experienced by the other countries in the region, but still it is important to analyze the development in the country where the political and economic reforms did not coincidence.

Other post-Soviet and former Eastern Block states would be mentioned throughout the work too, in the situations when the differences between countries belonging to the same group would be too serious to be ignored.

In order to prove the existence of the transition recession in the first part of the thesis several indicators are used. GDP is probably the most frequent indicator of the economic performance. Naturally it will be used to reflect the overall situation within the transforming economies. World Bank (2002), however, stresses the danger of the measurement of economic development solely by GDP: "…Estimating GDP and using it as an indicator of living standards have some well-recognized problems… [they] fall into three groups: index number problems, omission of informal activities, and effects of the changes on the composition of output..." [6] At the same time Blanchard (1997) proposes to measure the dynamics of industrial production (and generally the distribution of GDP by sector), aggregate labor productivity, and registered unemployment to get more realistic evaluation of the transition recession. Alsund (2002) highlights the importance of inflation, GDP per Capita in PPP, and social inequalities (GINI estimates, poverty ratios, etc.). Basically, these indicators are sufficient to prove the fall in output and overall recession in all the selected economies. The materials of the World Bank would be used, together with World Development Indicators Database, supplemented by the data from de Melo et al. (1996) and Stiglitz (1999). In the second part of the work other development indicators are added into the analysis. EBRD Transition Progress Indicator (TPI), Liberalization index (EBRD), Human Development Index (HDI), Initial conditions index (from Hare (2001)), Index of institutional quality (from WEO (2000)), and other indicators of overall development are relevant here. Soviet growth rates (during Soviet period measured solely by Net Material Product) are taken from the joint report by the World Bank, IMF, OECD, and EBRD (1990) summarized by Lavigne (1999).

There are also limitations in the research. There must be given a discount for the empirical side of the analysis. The sources differ in their estimates; sometimes the variations are valuable. The particular problem appears when the socialist determinants are estimated, since there are gaps of 'true' information on several important development indicators during Socialist period as, for example, the rate of unemployment, inflation, social inequalities, etc. Since the transformation in the post-socialist economies is unique, there is no consensus between experts on the choice of appropriate strategy and the reasons for transitional recession. The existing materials differ in their conclusions. There are no solutions working in the exact manner in different countries so far.

Plus, selecting six representative countries out of all those transforming after the collapse of the USSR means pointing to the general tendencies within the groups they represent, so some degree of generalization is allowed. The main goal of the thesis is in analyzing transition recession in general and discovering the reasons for the divergent outcomes throughout the region on the example of six countries. The broader issues as reasons for the collapse of the centrally-planned economy and the advanced analysis of the appropriateness of the individual economic measures are not the primary priority of the research; however, that connected with the topic would be mentioned as well.

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[6] The WB: *"Transition. The First Ten Years"* (2002) pp. 8

1. Post-Socialist transition in the modern economic science

The transformation process in the post-socialist countries seems to be one of the most *important events of the second part of the XX century. The question is whether transitology can* be treated as a separate field of the economic analysis. Notwithstanding the relatively low level of attention paid to problems of comparative economics and development among the Western economists, the most influential specialists did not stay apart from the problems of economies in transition. At the same time these problems became a challenge for the western economic science (and its particular divisions) in the sense that the dominant theories could be tested for sufficient explanation of the real performance in countries going through transformation. The success of policy advices given by the West to the transition economies could be analyzed.

There are two approaches to transitology in Western universities. In the US, the subject is usually taught as a part of the applied macroeconomics course or in the form of inter-disciplinary analysis oriented towards regional studies (economic side of transformation is reviewed together with political, social, and historical perspectives). However, the majority of European universities assume the separate course on the theory of transformation and transition economies performance. This difference can be explained by the domination of neo-classical (mainstream) school of thought in the US and the European preference of institutionalism and evolutionary economy.[7]

1. 1. Rise of transitology

The rise of transitology was controversial. The reason for that was hidden in the differences in interpretation of the centrally-planned economic systems in the Western economic literature.[8] The socialist economy was analyzed on the different levels of abstraction (this difference was later reflected in the debate over the appropriate transformation strategy, namely big-bang vs. gradualism). Lange, Lerner and other proponents of the Market Socialism interpreted the situation on the biggest level of abstraction. They assumed that centrally-planned system was a logical alternative to market economy. The main idea of Lange model of Market Socialism was that state-owned property could be effectively combined with the markets that would determine the prices for consumer goods and wages. This theoretical contribution was generated as a result of so-called "Socialist Calculation Debates" between Lange and von Hayek (and also von Mises) in the 1930s. Lange believed that his model achieved something closer to "perfect competition" than capitalists could claim under the capitalist system of private

[7] Martynov A., Avtonomov V., Osadskaya I. (2004) pp. 19-21
[8] Martynov A., Avtonomov V., Osadskaya I. (2004) pp. 20

ownership of productive property and markets (so author tried to take the best from both planned economy and market economy).

What is interesting, theorizing of pro-market neo-Austrians was more concrete, blaming Market Socialism for concrete weaknesses (for example, imperfect information problems, etc.). Their main objection was that "...Since [socialism] precluded the possibility of private ownership of the means of production, no market prices that reflect the relative scarcities of resources could emerge... Without market prices to guide production, socialism is unable to rationally allocate resources among competing ends..."[9] Thus, the correct economic calculations would not be available.

However, the debates around socialism were still too abstract; both sides did not rely much on the day-to-day performance of socialism in the USSR and its satellites in Europe. Neo-classical economists rarely theorized on concreter levels, with an exception of Kornai. He introduced Soft Budget Constraint (assuming soft subsidies, soft taxation, soft credits, or soft administrative prices) already in 1979 to enlighten the economic behavior in socialist economies marked by shortage.[10]

New institutionalists were more active in this sense, proposing the theory of Yugoslavian firm belonging to its workers (a participative system) as a possible scenario of transition. The dominant role over the decision-making process of the firm belonged to the workers through the share-holding, according to Professors Kouba and Mlčoch of the Charles University (Prague).[11] But, besides the participative system of former Yugoslavia, the interest was also caused by the popularity of ESOP schemes (Employment stock ownership plan) in the West at those times, mainly in the US as an method to increase the interest of the workers in the better productivity of the firm (to increase the value of their own shares). It could be beneficial, for example, in the bankruptcy situations, when ESOP provided the way to rescue the working places.

Economic comparativists and sovietologists were even more concrete in their analysis. Marshall Goldman, Alec Nove, and others used mostly a describing method, highlighting the differences between two systems. Through this approach they tried to illuminate the sustainability of the planned economy. Various theories were also at the middle position. Euken, Professor of Economics at the University of Freiburg gave birth to the theory of economic systems, which was not built to overemphasize the differences between them, but to assume a co-existence of the elements of both systems (centrally-planned and market economies).[12] But the works of Veblen style institutionalists (J. K. Galbraith and R. L. Heilbroner) got even greater

[9] Boettke, P. and Leeson P. (2002) pp. 3
[10] Kornai, J., Maskin E., Roland G. (2002) pp. 2
[11] Michal, J. (1994) pp. 202
[12] Eucken, W. (1951) pp. 295-318

popularity. Their main idea was in the convergence of socialism and capitalism in their optimal synthesis. However, their assumptions were not based mainly on the knowledge of the performance of the real socialism and were oriented towards discovering the fundamental weaknesses of the market economy.

All the concepts mentioned above were based on the dichotomy between the centrally-planned economy of the Eastern block and free market economies of the West. The rapid crash of the socialist economic systems was consequently unexpected to come so soon by the Western economic science. According to the opinions of Martynov, Avtonomov, and Osadskaya (2004), sovietologists overloaded themselves with empirics and theoreticians were not aware of the real developments of the socialist systems.[13]

Publication of selected chapters on transition economies by Hare and Davis (1997) is a very important contribution that gives the idea of transitology as a separate research area a valuable ground.[14] Other fundamental works concentrated on transition economies are of Gregory and Stuart (1998) and Gros and Steinherr (1995). The former highlighted the importance of economic history for the transition theory, and the latter is mainly based on the theoretical analysis.[15] At the same time authors suppose that there is no unified theory on transition, but separate frameworks designed to solve different problems. Havrylyshyn (2006) believes that: "…It was very commonly said that there is no theory to guide the practical process of transition, only theories of capitalism and socialism…a new consensus paradigm has not emerged from the vast literature on transition… [but] a formal unified theory is not needed to understand the main developments…it is useful to have a compact rather than complex analytical framework".[16] Particularly, when the works of Blanchard (1997) and Kornai (1994) are combined, they suffice to provide "nucleus" of a transition model.

Kornai (1994) did not pretend to build up a benchmark transition model. Instead, he focused mainly on the phenomenon of transitional recession and its uniqueness (if compared with a market economy recession). Consequently, he highlighted two important policy actions that are needed for a successful transition: price liberalization (to force a move from sellers' to buyers' market) and also privatization and elimination of governmental support as subsidies, low-cost credits, and tax exemptions (to enforce a hard budget constraint).[17] Blanchard (1997), on the other hand, tried to explain the transitional recession by focusing on the mechanisms of resource reallocation from old inefficient enterprises to new efficient ones. The core of the process was comprised of two elements according to author: reallocation through closures and

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[13] Martynov A., Avtonomov V., Osadskaya I. (2004) pp. 21-22
[14] See Hare and Davis (1997)
[15] See Gregory and Stuart (1998) // Gros and Steinherr (1997)
[16] Havrylyshyn, O. (2006) pp. 16
[17] See Kornai (1994)

bankruptcies combined with establishment of new enterprises; and restructuring of surviving firms (via labor rationalization, product line change, and new investment) – very reminiscent of Shumpeterian concept of "creative destruction".[18] Actually, the process of first establishing new incentives for economic behavior, and then making decision-makers react to them by efficient reallocation of resources is able to bring the economy to a new market equilibrium (with an optimal allocation and comparative advantage). According to Havrylyshyn (2006), "…The combination of these four components of transition do not of course provide step-by-step guidelines the policy-makers have to implement, but a useful paradigm must be simple and only need to provide a central network of thinking around which the details can be logically constructed".[19]

The process of transformation of centrally-planned economy into market economy is strongly country-specific (that is determined by the length and nature of the socialist period and the political situation in every transforming country). At the same time, the economy in transition is not a balanced system with strong self-stabilization tendencies, in contrast to both market and socialist economic systems. The success here is based on the individual behavior of politicians, namely, on their experience and proficiency in state administration. Thus, the problems of economies in transition can be addressed more to the arts of economic policy rather than to the theoretical considerations behind the reforms. Nevertheless, if the economic theory is viewed broadly, the literature on the economic transition can be treated as a part of it. It should be kept in mind that the analysis of problems in transition economy (relationship between politics and economics, the logic of institutions functioning and the order of their creation, etc.) made an effective contribution to the development of the economic science in general.

Basically, the transition is a highly disputed topic in political science too. Transitology paradigm is one of the theories dealing with the move from an autocratic regime to the democratic one and is distinguished from other models by its linearity (the view that once the change is initiated, it inevitably moves towards democracy). The change became a goal of the broader analysis after the publication of four-volume study by O'Donnell and Schmitter (1986) that was mainly concentrated on the democratization process in Latin America. Carothers (2002) has pointed out the key assumptions underlying the paradigm: any country moving away from authoritarianism is moving towards democracy; democratization takes place in a set sequence of stages; elections are the key to democratization and further democratic consolidation; the structural conditions of democratizing countries (level of economic development, ethnic

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[18] See Blanchard (1997)
[19] Havrylyshyn, O. (2006) pp. 16-17

composition, historical experiences, etc.) are not crucial for the outcomes, etc.[20] However, transitology paradigm was heavily criticized, notwithstanding the fact that it became a powerful creed of the democratization studies. For instance, it was blamed for being too deterministic when assuming that each democratizing country goes through a similar set of stages and generally the processes are similar, as for example in Fish (1999).

The structuralist explanation was an alternative theoretical approach to transformation. It focused on economic, social, and cultural preconditions of democracy, believing that a country with better positions in terms of these three aspects have a greater chance of experiencing democratic breakthrough and sustaining a democratic political system. Other alternative explanations included ideas that level of institutional pluralism at the pre-reform stage did matter, as well as a functioning political parties system, and the balance of powers. Notwithstanding the frequent challenges, the transitology paradigm continues to dominate in political literature, mainly due to the inability of opponents to build a complete alternative theory, critics is too diversified, and the empirical basis is unavailable.

The linkage between political liberalization and market liberalization has been impressively explained in McFaul (2002): "... [Many had predicted that] reorganization of economic institutions would undermine democratic transition...to the contrary those countries that have moved the fastest on economic transformation also showed the greatest success in consolidating democratic institutions..."[21] Here it can be recalled to big-bang – gradualist debate, which actually ended up with the similar conclusion. For instance, Barcelowicz's preference to shock therapy method can be explained by the vision that "...Early democratization facilitated economic reforms, providing a historical opportunity to give the population its first desire: a move away from communism...a big-bang approach [could create] as much of the market as possible before the honeymoon ended".[22] The conclusion is that there is certainly a correlation between democracy and market liberalization; however, the relationship is not strong enough to become a viable solution.

1. 2. Principal debates of the 1990s

At the mid-point of transition a number of reviews of progress were undertaken. The World Bank's Annual Development Report of 1996 has stimulated the revision of the results, which were conducted for example in Murrell (1996) and Stern (1997). More recently (after 10 years of the process), several other reviews were produced. One of the most influential belonged to Nobel Prize-winner, J. Stiglitz (1999), a Chief Economist of the WB at those times. The

[20] Carothers, T. (2002) pp. 5-21
[21] McFaul, M. (2002) pp. 221
[22] Havrylyshyn, O. (2006) pp. 45-46

IMF's annual World Economic Outlook (2000) focused on transition in an official statement. The recent studies of Svejnar (2002) and Campos and Coricelli (2002) concentrated mostly on the recovery of the fall of output in transition economy.[23] The analysis went as far as to the idea that the socialist transformation should to be treated within the framework of the theory of modernization of the Third-World countries and its position grew over time. The Second World in this perspective looked more like a Third World, and it was performing even poorer that Third World countries in terms of the development of market institutions (in the case of CIS countries).[24] The issues covered in these papers are enough to show the tendency of non-agreement between the Western analysts. The various theories of transition have been developed due to the variance of opinions about the nature of the centrally-planned economy. The debate about the most controversial sides of transformation was another result of the divergent position towards socialist economy. The debates seem to be logical, if we take into account the differences in perception of transition between different schools of economic thought.

So, the dozens of issues produced by the literature mentioned above can grouped into eight main debate areas determined either by the intensity of the debate or their today's relevance. Havrylyshyn (2006) classifies them as follows: [25]

- The debate on speed (big-bang / shock therapy / rapid reform on the one hand vs. gradualism on the other);
- The related debate on the best approach over privatization strategy (comparing vouchers, direct sales, insider sales, etc.);
- The sequencing and adequacy of development of market institutions and the rule of law;
- The relationship between market liberalization and democratization;
- The debate over the reasons for the unexpectedly large output fall;
- The large difference in reform and growth performance between Central Europe, Baltic states, and South-Eastern Europe on the one hand and CIS countries on the other hand;
- The large social costs, rise in inequality and increased poverty incidence;
- The comparison with China's less disruptive transition.

The distinction should be made between positive and normative science. The latter of course prevails, since the demand for practical recommendations is greater in this subject that the objective reflections of the development. A central problem of the normative economic science deals with the search of the optimal tempo of the reform and the correct sequence of the changes. Probably the biggest normative debate covers the choice between rapid (big-bang) reforms and gradual transition, the first item in Havrylyshyn's classification.

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[23] Svejnar, J. (2002), pp. 1-33 // Campos, N. and Coricelli F. (2002) pp. 793-836
[24] See Krasilshikov, B. (1998)
[25] Havrylyshyn, O. (2006) pp. 21

During the early stages of transition the popular vote was naturally given to the opponents of Socialism. They were most successful in proving the principal non-sustainability of the socialist system and pointed to the benefits of market economy (based fundamentally on political democracy and individual freedom). Balcerowicz (1993), Klaus (1995), and Sachs (1994) advocated of seizing the moment of political opportunity and implementing the major feasible changes as quickly as possible, so called shock therapy. Basically, the proponent of the rapid reforms assumes that a man is well-informed and rational. His behavior is determined by the current incentives within the society instead of historically developed institutions (negative path-dependency). It is actually enough to create incentives and the interests would do the rest. Technocrat that is free of personal interests and bias is the one that creates these incentives. He also knows where "to lead" the society. The society by itself is not needed to participate in the transition process, because in many perspectives it is even harmful (due to the variety of conflicting views). It is believed that partial and slow reforms distort the transition and thus make it more expensive. Besides, this approach makes it is easier to overcome the political resistance to the reforms.

Aslund (2002) has summarized the distinctive points of the strategy.[26] First, the immediate concern was in stopping hyperinflation that required elimination of a large budget deficit. So, the fiscal policy had to be centralized and brought under control by a reinforced Ministry of Finance. Then, for the same reasons the monetary policy must be tightened, besides, the positive real interest rates were necessary. The Central Bank had to become independent. Prices had to be deregulated to let supply and demand determine prices. Also, the domestic trade should be liberalized and monopolistic pricing should be avoided. The currency needed to be convertible on current account to be freely available for foreign trade and the exchange rate had to be unified. A free foreign trade regime should be established, eliminating rents in exports and imports. Free trade would alleviate the shortages, facilitate production, and boost the living standards. Restrictions on the private sector should be abolished, and new private entrepreneurs should be offered a maximum of freedom. In order to realize this goal, Aslund continues, a small-scale privatization should be initiated early on and the privatization of large and medium-sized enterprises should be started as soon as possible even though it would take time. Finally, the restructuring required introduction of a social safety net targeted to new groups in need, especially unemployed and reinforcement of pensions. As of the speed and comprehensiveness of the reforms (mainly being a source of the debate), radical reformers believed that: "...The system must achieve a certain degree of cohesion and consistency...Otherwise, it could theoretically be even more inefficient that the old command economy...The reforms had to be

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[26] Aslund, A. (2002) pp. 77

radical, comprehensive, and fast to break the hold of the old system and introduce a viable new market economy".[27]

Simultaneously, the reforming countries did not have a comprehensive explanation of the movement from one system to another and did not have an own strategy on the transition. At the same time the policy recommendations by World Bank and International Monetary Fund were already available, so they were purchased and implemented. What is interesting, WB's pressure was done usually through a persevering persuasion; the credits from IMF were accompanied by the concrete macroeconomic conditions (and even structural ones for bigger credits).[28]

During 1980s these organizations together with the Ministry of Finance of the US have developed the policy advice towards the developing economies (in Latin America mainly), that was later used by the transforming economies as well, called Washington Consensus (WC). It was a set of policies promulgated by neo-liberals as a formula to promote the economic growth through introduction of various market-oriented economic reforms which were designed to make the target economy more like that of First World countries such as the US.[29] WC was first presented in 1989 by John Williamson, an economist from the Institute for International Economics (Washington, DC). It assumed that: the economy was regulated by the pricing mechanism, so the price and market liberalization was an ultimate goal; market mechanism had to cover the production, exchange and reallocation of goods, services, and factors of production. Privatization was a principal tool allowing realizing this goal and also to increase the overall productivity. Other elements of the policy change proposed by the defenders of Washington Consensus were: macroeconomic stabilization, liberalization of the exchange and trade system; establishment of a competitive environment with easy market entry and exit; and redefinition of the role of the state as a provider of macro stability, a stable legal framework and enforceable property rights, and occasionally as a corrector of market imperfections. WC is illustrated in Figure 1.1 [30]

The basis of strategy was substantial. The traditional neo-classical approach treated the transition as a movement from a balanced point A (centrally-planned economy) to a balanced point B (market economy) that exceeds point A under criteria of Pareto optimality. The finish position does not depend on the way it undergone (path independence), so theoretically the sequence of the reforms does not make a crucial difference on the result. The mass privatization proposed in WC is, for example, based on the Coase theorem, which says that the factors of production will naturally come into the hands of the most effective owners. The proponents

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[27] Aslund, A. (2002) pp. 79
[28] Fisher, S. (1997) pp. 23-27
[29] "Washington Consensus" [Wikipedia]
[30] See Figure 1.1 p. 93

argued that there was little choice in the context of the economic and political crisis facing these countries and that the WC provided for needed flexibility on both speed and sequencing, and in the event the outcome was generally favorable.[31] It is a so-called ideology of the WC.

Moreover, the recommendations of specialists working in the international financial organizations were influenced by the ideas prevailing in the advanced circles of global economic science at the moment. Thus, in 1970s and 1980s the ideology of WB and IMF was dominated by the ideas of a conservative renaissance including monetarism, supply-side economics, the Chicago school philosophy and, basically, the new classical macroeconomics (based on the concept of rational expectations and critical towards a systematic macroeconomic policy by the state). A visible attention was paid to the problems of governmental failures, monopolization and state subsidizing. So, during the time of the development of WC the scientific dominance belonged to the ideas of the development of markets and liquidation of protectionism, state subsidies and state property. Edwards (1997) points out that export orientation (to counterbalance import substitution) and liberalization of the foreign trade (to counterbalance protectionism) lead to the optimal results in the economic growth.[32] The other consequence was in exclusion of traditional Keynesian receipts of stimulation of the economic performance through budget deficit. The openness of economy (in trade, investment, technology, and information) was believed to be crucially important for its progress, despite the fact that some problems were partially neglected.[33] Finally, the pragmatic side of the recommendations was always valuable. Active payment balance, non-deficit budget – these goals can be explained by the common sense, so, by the anxiety of the creditor about the return of money. So, the short-term macroeconomics of IMF is based on three fundamentals: the balance of the Central Bank, payment balance, and the state budget. Consequently, IMF focuses on such recommendations to the country that would allow paying back the loans as the first priority.[34]

However, the authors of shock therapy were not always belonging to the neo-classical school of thought. For instance, the main Polish "shock therapeutist" L. Balcerowicz was actually Veblen-type institutionalist, according to his book *Socialism, Capitalism, Transformation* (1995).[35] It can mean that the choice of the strategy was dictated mainly by the political situations in the countries rather than by the theoretical predilections of the state officials.

On the other hand, there were also those advocating for a more gradual approach to the transition to minimize disruptions, output and job losses and consequent reversal of political will,

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[31] IMF: *"World Economic Outlook..."* (2000) pp. 91-95

[32] Edwards, S. (1997) pp. 46

[33] As, for instance, too great freedom of the movement of capital inside and outside of the country

[34] Martynov A., Avtonomov V., Osadskaya I. (2004) pp. 27

[35] See Balcerowicz (1995)

as Aghion and Blanchard (1994) and Dewatripont and Roland (1992). The views of gradualists were various. Aslund (2002) grouped them into three categories depending on the main ideological directions.[36] The first group consisted of those who opposed a normal market economy, but did not want the old system (particularly the influential politics and rent-seekers that benefited from the inconsistencies of the transition). The second group consisted of left-wing economists that basically accepted the market economy but tried to develop a complete alternative program of gradual reforms. The author mentioned that their position became less socialist over time, since they fully accepted the existence of a democracy and free market relations. They saw the success of a Chinese model of transition as a basis for its implementation in the former Eastern Block too. The third group consisted of specialists on political economy. The literature in the field was largely based on assumptions that radical reforms were more socially costly that gradual changes, so the tradeoffs between reforms and social costs were inevitable.

The majority of arguments of gradualists have been conducted through theoretical models. Gradualists believe that economic behavior is not solely determined by the incentives structure, but also by the role of the historical past (reflected through institutions). The knowledge required for the reform implementation cannot be generated by any technocrat or state official. In contrast, the knowledge appears out of experience, and it is determined as well by the structure of existing institutions. Institutions cannot be introduced from above. They change extremely slowly over time; moreover, if the formal institutions (laws, regulations, etc.) can be changed over night, informal ones (moral and social norms, habits, etc.) require years to change.

The instruments of course cannot be predetermined and strict; the problems are ideologically burdened, so the special attention is given to the use of rhetoric: metaphors, analogies, etc. The famous "Battle of Metaphors" by J. Stiglitz (1999) impressively illustrating the differences between the approaches is shown in Table 1.1.[37] The reference to metaphors allows analyzing two approaches on the biggest level of abstraction and find out the areas of the fundamental difference. For instance, both radicals and gradualists refer to the Capital metaphor (not included into Stiglitz's list). But, if the former speak about the political capital (initial and non-revolving credibility the reformers get from the public, in contrast to the capital in its general understanding); the latter refer to organizational or social capital that includes all the routines, under which the society lives on the micro– and macroeconomic levels. This capital depreciates under the radical reform scenario, and its accumulation requires a very long time,

[36] See Amsden et al. (1994); Nolan (1995); Goldman (1996); Chen, Jefferson, and Singh (1992); Stiglitz (1999)
[37] See Table 1.1 pp. 94

according to Stiglitz. The gradual transition in this sense would allow using the social capital that was inherited from the past (for example, in the form of moral norms and collectivist ethics). Another difference in perception between radicals and gradualists can be illustrated through the metaphor on the role of the state in transition. Proponents of the shock therapy treat the state as it is limited and scarce, since it consists of limited financial and competent human resources; and, at the same time the sphere of state's responsibility is much greater.[38] Another rhetoric method that highlights the differences is the use of analogies. Gradualists refer to the Chinese model and Russian model (former as a positive example and latter as a negative one). Radicals, in contrast, blame the Chinese model for being too specific and for the impossibility of imitation. Their ultimate goal is the way Central Europe and Baltics undergone, and they criticize CIS countries for the collapsed shock therapy (that lead to a long and painful transitional recession).

It should be kept in mind that different schools of economic thought reacted differently on the topic and the fundamental differences between them was reflected in the diversity of opinions. While mainstream economists supported the radical scenario, gradualist approach was accepted by some alternative schools of thought. For example, post-Keynesians, rejecting neo-classical general equilibrium models and emphasizing the role of uncertainty, insisted on the idea that economic processes happened in a historical time and their performance actually determined the outcome (path dependence).[39] They actually believed that a capitalist economy had no natural self-equilibrating tendencies and thus emphasized the need for governmental fiscal policy to support institutions, especially within the framework of the transition economy. According to Havrylyshyn (2006), "...the institutionalist view lies in between, admitting the need and usefulness of moving rapidly on stabilization and liberalization but cautioning that institutional developments have to begin in parallel and be sufficient to ensure the intended benefits of market reform" – as expressed in Murrell, Clague and Reuser (1992).[40]

The evolutionary economics (based on Shumpeter's theory of economic development, late von Hayek, ideas of economic sociologists; and developed later on by Nelson and Winter) is also a potential candidate to explain the problems of transitional economics. The phenomenon of *embeddedness* of economic performance within the social context is highlighted pointing to the fact that only that institutions and norms are able to operate within the society that are embedded in this society. Consequently, the ways of reforming should be different for different countries in the region, they cannot be held under the single plan or directive. There also exists an opinion that the rapid elimination of old institutions would not be beneficial since the structure of the institutions should be diversified. Besides, Grabner and Stark (1996) and Smith and Pickles

[38] Balcerowicz, L. (1997) pp. 132
[39] See Kregel, Matzner, and Grabner (1992)
[40] Havrylyshyn, O. (2006) pp. 23

(1998) believe that the institutions that are optimal for the transition period would be sub-optimal in the future. It is symbolic that evolutionary economists prefer to call the process "a transformation" instead of "transition" highlighting the fact that the movement is not a simple change of one model into another model, but a move towards the unknown future, not predetermined at the initial stage of reformation.

The movement towards the revision of the Washington Consensus was headed by Joseph Stiglitz (1999), the Chief economist of the WB.[41] That is symbolic, since the official position of the WB was always advocating the WC. The critics arose even before him, but the fact that now it was criticized by such an important figure, added a serious weight to the gradualist position.[42] Probably the impact of the implementation of shock therapy on the institutions was the biggest challenge to WC. Here it is much easier to destroy the existing system that to create the new one, especially under the condition of Schumpeter's Creative destruction as a force sustaining the further economic growth.[43] Consequently Stiglitz believes that the institutional vacuum should be avoided at any price. Particularly, the critic is directed towards voucher privatizations in Russia and Czech Republic: "...Those advocating rapid privatization faced the quandary that there were no legitimate sources of private wealth within the country with which privatization could be accomplished"[44] Stiglitz's position is based on the pure institutionalist argument: there is a lack of institutional structures in the transition economy (in contrast to a market economy), so the long multistage chains of agency relationships networks between numerous principals and agents do not work properly. In *The Problem of Social Cost* (1960) Ronald Coase had formulated a theorem where the well defined property rights could overcome the problem of externalities (that was relevant to the area of transition economies too), but it should be kept in mind that Coase theorem is correct only with the assumption of zero transaction costs that are extremely high in transforming economies.

Besides, WC is criticized for the wrong sequence of the reforms: the restructurization of industrial organizations and state management and legal systems should be held prior to liberalization and privatization, and the sequence is crucial. Moreover, other critics of WC highlight the bounded role of state (underestimation of its role of architect of an institutional structures and a manager of the process of globalization of national economy). Simultaneously the opponents of WC agree with the need of fiscal discipline, liberalization, and inflation suppression. But they stress the importance of active managerial role of the state, effective

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[41] Stiglitz, J.E. (1999) pp. 3-29
[42] Zecchini, S. (1997) pp. 250-251
[43] Schumpeterian "Creative destruction" describes the process of industrial transformation that accompanies radical innovation. Innovative entry by entrepreneurs is the force that sustains long-term economic growth, even as it destroys the value of established companies that enjoys some degree of monopoly power
[44] Stiglitz, J.E. (1999) pp. 6

corporate governance, a stable banking system, a degree of protectionism in the foreign trade, production of public goods, and also political and geographical factors.[45] So, there are two streams of criticism of the shock therapy approach so far. On the one hand, the general neo-liberal approach was correct, but the implementation was weak, especially in Russia ("too little shock"). On the other hand, the neo-liberal design was not correct in its nature, because has proposed "one-size-fit-all" solution totally non-applicable in this problem ("too much shock, no therapy").

The gradualist position has weakened over time by several counter-arguments. Mathematical models of gradualists have actually derived to the opposite conclusion: under certain conditions big-bang was actually the best strategy. Then, the evidence on growth at least until 2000 was more consistent with the rapid reform. Also, evidence on social costs showed they were smallest for the rapid and early reforms. Finally, the evidence on rent-seeking tendencies in transition countries assumed that gradual reforms increased the probability of state capture, which could negatively affect the long-term growth.[46]

Concluding on the shock therapy – gradualism debate it should be kept in mind that there is a dichotomy in literature: theoretical analysis tends to conclude gradualism is better, while empirical analysts find that early and quick reforms result in an earlier and stronger recovery. IMF has come to a critical conclusion on the transitional process in "The World Economic Outlook" (2000): "...Countries that adopted a two-pronged strategy combining macroeconomic stabilization and comprehensive structural reform were, on the whole, more successful in limiting the output losses at the outset of the transition and achieving robust growth subsequently...Delaying certain key structural reforms (price and trade liberalization, and the elimination of soft budget constraints) has typically been associated with higher and more protracted inflation and a less robust recovery from the initial output fall"[47]

Other transitional debates were produced within the positive science. Probably biggest challenges to the positive economics are explanations of the negative effects of the transitional recession and the variations in the economic performance of transition countries. Last four issues in Havrylyshyn's classification exactly match this approach; they simultaneously fall under the scope of interest of this research.[48] The common methods used are the formal mathematical models (multi-variable regression equations), econometric calculations (even though the bad quality of statistical data blurs the conclusions) and the comparative analysis. Chapter 2 of the thesis deals with these issues in a greater detail.

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[45] Martynov A., Avtonomov V., Osadskaya I. (2004) pp. 29
[46] Havrylyshyn, O. (2006) pp. 25-26
[47] IMF: *"World Economic Outlook..."* (2000) pp. 120
[48] However, the last issue (comparison with China's less disruptive transition) is out of the scope of this research

Few words should be said about the topics that still have to be resolved; namely, the development of market institutions and the relationship between markets and democracy. The future of the countries of the Central Europe is dominated by the accession to the EU, and their performance would be determined by this powerful institution. But the countries of CIS do not have an intensive external assistance, so they have to decide by themselves about the strategies of solving these problems. Here the distinction should be made between two paradigms – "Transition Inevitable" and "Transition Frozen".[49]

On the one hand, some economists believe that once a minimum of stabilization, market liberalization and privatization is achieved, further progress in transition is inevitable – (Transition Inevitable). TI paradigm does not focus solely on the "critical mass" of democratization, but highlights the value of property rights: the new capitalists want to secure their property rights and thus create a demand for the rule of law, order, and transparency. This position is based on the works of Shleifer (1997); Aslund (1997); Aron (2003); World Development Report (1996); Boycko, Shleifer and Vishny (1995); Boone and Rodionov (2001) and others. On the other hand, there is a conditional view on this inevitability, arguing that where the reform process allows vested interests to build up quickly and benefit from rent-seeking opportunities of partial liberalization: "…they acquire a concentration of state assets in opaque privatizations to become what is popularity known as the oligarchy, and finally capture of the state" – (Transition Frozen). Proponents of TF vision believe that capitalists will favor rule of law only if it is in their interest. Factually, TF is different from TI: "…[In] the empirical proposition that in some cases – Russia and other CIS countries – it is not in the interest of the new capitalist class holding concentrated ownership of assets".[50] Thus, a concentrated ownership is not favorable to competitive efficiency or further liberalization. The main idea is that state capture by powerful oligarchs is not an intermediary point to a market economy, but a sustainable economic equilibrium based on profit maximization principles. Main objectives of TF approach are expressed in Hellman (1998), Buiter (2000), Havrylyshyn (1995) Polischuk and Savvateev (2004), etc.

So, the transition from a socialist command economy to free market relations continues to be an area of numerous scientific debates. The short overview of the western transitology (economic and political transition theories) should be treated as a preface to the following analysis of the differences among countries in their economic outcomes. It is clear that the normative approach (performed through Washington Consensus) did not pay enough attention to the differences among the countries implementing it, so the success of the strategy varied greatly

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[49] Havrylyshyn, O. (2006) pp. 39-41
[50] Havrylyshyn, O. (2006) pp. 39-41

throughout the region. The success seems to depend on the specific conditions in each case, so a single set of recommendations does not produce similar results, the gap is valuable between Central Europe's advanced economies and the less developed countries (non-European precisely). However, the important results were also generated throughout the last decade, and many of them are crucial for the understanding of the transition process in general. Further chapters will focus on the related theoretical considerations in a greater detail.

2. Recession during transition

When the transition began, the mass recession hit all the economies. In contrast to the countries of East Asia, post-Socialist transformation was visibly a more expensive process. Striking features of the post-Socialist transformation were: extended decline in output, rise in unemployment and inflation (even hyper-inflation in several CIS countries), deterioration of general well-being and social inequality growth. Figure 2.1 illustrates the output and inflation performances in several groups of countries – EU accession countries, Baltic States, Southeastern Europe, CIS, and East Asia.[51] It is visible from the graphs that even though the developments are different, the trend is similar for those countries that implemented big-bang scenario: the visible decline in overall economic performance and large social costs as a consequence.

Actually, the transformational recession was not a surprise to economists. The U-shape growth development in the transforming economies was examined in detail in numerous works for example in Blanchard (1997), Kornai (1994), Campos and Coricelli (2002), Aukucionek (1995), etc. But the actual levels of the decrease were not predicted. The unexpectedly large output fall continued to be an important element of gradualism criticism despite the clear evidence by the late 1990s that those economies which reformed earliest and fastest declined least. For example, Roland and Verdier (1999) recognize Central European countries which performed earliest are now growing again, nevertheless go on to say the policies of the WC led to unexpected outcomes, such as the important output fall which was not predicted.[52]

Those implementing the rapid scenario understood the fact that they would have to pay the price of the transition. For example, "500 Days" reform program in Russia in the beginning of 1990s mentioned the possible output decline after 100 days of reforms: "...It should be kept in mind that the decrease in industrial production (especially in basic industries) will come with the

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[51] See Figure 2.1 pp. 95
[52] Roland and Verdier (1999) pp. 26

fall in investment activity".[53] The unexpectedly large decline continued to be an important element of gradualist criticism despite the evidence by the late 1990s that those economies which reformed earliest and fastest declined least. So, even though the decline was predicted, its causes and depth became a source for the debates in literature.

The effect was so strong that it started to be characterized as "higher and more persistent than during the Great Depression".[54] Actually, the comparison between transition recession and the economic crisis (usual to the market economy) gives several interesting conclusions. Martynov, Avtonomov, Osadskaya (2004) deeply analyzed the circumstances, comparing Russian recession with the one of US's Great Depression. They found out that the similarity was in the speedy fall in the level of the overall economic performance. However, the fundamental difference with the US cyclic crisis was in three dimensions. First, the trajectory of the decline was very similar in US (1929-1934) and Russia (1991-1998). In both cases there was an alternation of acute (fast) and flat (slow) phases of the production decline. However, the length of the sharp phase in the case of Russia was 1.5 higher that in Great Depression and 3 times higher that in the average US cyclic crisis. Then, the transitional recession in post-Socialist country was complemented with a great structural change. If the service sector in Russia was not expanding that rapidly and the declining trajectories of decline in material sector and service sector were similar (as during the Great Depression), the overall level of GDP would decrease by more that 20 percent. Finally, comparing the investment activities in both cases authors came to the conclusion that Russian crisis was not complemented with the fatal disinvestment, as in the US. In this perspective, the transitional recession can be characterized by the absence of an investment crisis.[55] Consequently, the transition recession is unique and is caused not only by pure economic conditions.

On the other hand, the recovery after the initial decline was done through several measures. First, the control over inflation became a main goal of the policy-makers, since the majority of countries were hit by inflation rate of over 100 percent a year. Then, internal and external liberalization was mentioned in many works, since the first cross-country regressions on transition economies established that economic growth is positively correlated with reform progress. Privatization was a key structural solution to the transitional recession. Institution-building has been addressed as the crucial factor of the semi-success in the reform, since it required more time than other reforms.

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[53] Martynov A., Avtonomov V., Osadskaya I. (2004) pp. 49-50
[54] Havrylyshyn, O. (2006) pp. 81
[55] Martynov A., Avtonomov V., Osadskaya I. (2004) pp. 56-58

2. 1. Causes

Members of the different schools of economic thought could not agree on the dominant reasons for the transitional recession. Schmieding (1993) has classified the causes of transitional recession by the belongingness to different schools (neo-classical, Keynesian, institutionalist): neo-classical economists highlighted the non-optimal reallocation of resources as a main reason; Keynesians pointed out to the role of the decline in consumer demand associated with stabilization measures; and institutionalists blamed transition economies for institutional vacuum leading to increased transaction and information costs and human capital devaluation.[56]

Kornai (1994) was probably the first to categorize the factors inducing the recession (on the example of Hungary). The first reason was that the move from sellers' market (supply-constrained economy) to buyers' market (demand-constraint economy) is complemented by economic recession: "… [The] process is to some extent consciously controlled by monetary and fiscal policy, as well as by pricing policy, out of a desire to bring shortage economy to an end…Ultimately, the economy on the macro-level tips from a state of excess demand to insufficient demand (that is one of the major causes of the decline).[57]

The second cause of the recession was seen in the transformation of the real structure of the economy. The new system of relative prices is established. The effect of foreign relative prices starts to work: "…The new relative prices and the concurrent new product composition of demand generate an adjustment in the supply, i.e., a transformation of the real structure of production…In this respect, the transformational recession has characteristics that are more Schumpeterian than Keynesian. It is not simply that aggregate demand is insufficient. The demand for the output of some sectors of the economy falls dramatically, while the demand for that of other sectors does not fall at all, but may actually grow…A painful process of natural selection takes place, but the trauma has a healthy, cleansing effect".[58] Blanchard (1997) has described the effect of restructuring on growth and unemployment. If state firms are to survive at all, they must restructure - redefine their product line, close those plants which are no longer needed, reduce labor hoarding, replace many of their managers. "…It is one of the reasons why output growth since the start of the recovery has been associated primarily with increases in productivity rather than with decreases in unemployment…Faster restructuring can lead to higher unemployment… Higher unemployment can in turn slow down restructuring".[59]

The third basic cause of the recession by Kornai (1994) is the disruptions in coordination – "no-man's land where bureaucratic coordination no longer applies and market coordination

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[56] Schmieding, H. (1993) pp. 216-253
[57] Kornai, J. (1994) pp. 40-44
[58] Kornai, J. (1994) pp. 45
[59] Blanchard, O. (1997) pp. 25

does not yet apply, and economic activity is impeded by disintegration, lack of coordination, and anarchy".[60] Author believed that this phenomenon took its ultimate form in many of the republics that have replaced the Soviet Union. Moreover, the development of market coordination takes time, which is the reason why the recession is protracted in many fields, but the period of development can be shortened by appropriate legal regulation and state initiatives, according to Kornai's policy recommendation.

The forth cause lies in the financial discipline, namely, a hardening of firms' budget constraints and a forceful implementation of bankruptcy legislation. Actually, some firms go bankrupt and exit the market, and the survivors (who use market instruments to fight for their survival from now on) economize on their expenditure better than they previously did, so their demand for inputs decreases. On the other hand the proportion of unemployed grows and less consumption demand is generated. All that effects are combined with the backwardness of the financial sector, the fifth category under Kornai (1994): the way in which credit risks are assumed (when they are motivated by non-commercial considerations) is totally irresponsible during transformation. The uncertainty rules both the commercial banks when they decide to lend on a broad scale and entrepreneurs when they plan to draw credit. Both think it is too risky. Again, author blames governments for lack of action: "... Hesitation and a lack of imagination have occurred in a field where there is a real need for constructive governmental initiative".[61]

Havrylyshyn (2006) adds the impact of disruption of soviet period supply links (disorganization under Blanchard (1997)) and trade disruptions with the end of the Council for Mutual Economic Assistance (CMEA).[62] Gomulka (2000) uses the example of Russian defense industry that had suffered the most "...For the collapse of the Warsaw Pact (and the associated contraction of the defense industry), of the CMEA (and associated contraction of trade) and of the USSR itself (and the associated disruption of intra-Soviet production links), have all been the largely inevitable consequences of earlier events...The reduction in the output of the defense and defense-related industries alone, according to one knowledgeable source, accounts for 60% of the fall in industrial production in Russia".[63]

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[60] Kornai, J. (1994) pp. 47
[61] Kornai, J. (1994) pp. 52
[62] Havrylyshyn, O. (2006) pp. 27
[63] Gomulka, S. (2000) pp. 7

2. 2. Empirical evidence

2. 2. 1. Output and unemployment trends

The official statement of the WB (2002) concluded that: "...The trend in real GDP for the CSB matches… what was expected at the onset of the transition… There was a sharp initial fall, followed by a fast recovery and then sustained growth at levels determined by factor accumulation and increases in productivity… Even for these countries, though, the initial fall was larger than anticipated…The output decline was far deeper and longer in the newly independent countries of the CIS, particularly with the incipient recovery in 1997 derailed by the fiscal-financial crisis in the Russian Federation the next year".[64] Poland has experienced the shortest and mildest recession (6% drop in industrial production over two years), the analysis continues, the three Baltic countries had the longest (5-6 years) and deepest (35-51%) recession among the CBS. In this perspective they are much closer to the average of the CIS than to other CSB countries. In the CIS, Armenia, Georgia, and Moldova saw the steepest declines (Georgia, for example, reached 80 percent fall in output), while Belarus and Uzbekistan mild declines. At the same time, Jeffries (1996) points out that the UN Economic Commission for Europe in 1994 claimed that it is possible that the present official figures overstate the depth of the fall in output, but it seems unlikely that subsequent revisions will transform the slumps in output into a mild recession.[65] The statistical error should be kept in mind when considering the macroeconomic measurement at the beginning of transition.

The transitional effect on the labor force was also sharp. IMF's "World Economic Outlook" (2000) says that employment fell in the early years of transition, but by much less than output. The total employment at the end of the decade was still more than 10 percent below its 1989 level in CEE. In the CIS countries employment has continued to decline gradually in recent years. Besides, in most transition countries prices increased substantially in the initial stage of the transition, as a result of price liberalization. The Consumer Price inflation was as growing as fast as 2400 percent annually (in CIS). The same trend of deterioration has occurred in the sphere of health, education, and R&D. Poverty and inequality became a constant attribute of the transition in some countries.

The decline of industrial production is rather valuable in all the six countries considered. Whereas the cumulative output decline in former members of the USSR and several republics of former Yugoslavia accounted for up to 40%, the former satellites in CEE were visibly better off in this sense: the highest recession of 23% was in Slovak Republic, according to the official statistics of WB (2002). Interesting conclusions can be drawn out of the aggregate statistics on

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[64] The WB: "*Transition. The First Ten Years*" (2002) pp. 4-5

[65] Jeffries, I. (1996) pp. 45

evolution of Gross Domestic Product and unemployment from *World Development Indicators* database, (Figures 2.2 and 2.3).[66] Havrylyshyn's chronology of events (post-socialist countries) is used for time and reform analysis.[67] Figure 2.4 is concentrated on GDP per capita (constant 2000 US$) and GDP per capita in PPP (in constant 2000 international $) for the six countries analyzed.[68] Figure 2.5 represents the position of countries in the Human Development Index list by UN Development Program Report (2003).[69] Figures 2.6 and 2.7 illustrate the evolution in industrial production.[70]

In Belarus, the lowest level of GDP was in 1995-1996, so after five years of transition. The fall was significant: from 12.876 billion constant 2000 US% in 1990 to 8.643 billion in 1996, so there was almost a 40% recession. At the beginning of 2003 the level became bigger that at the beginning of transition however. Consequently, the overall economic performance was U-shaped quite significantly in Belarus. GDP per capita has suffered a decline from 1.264 constant US$ in 1990 to 825$ in 1995, thus fell by 35%. The recovery came in 2002 (1.265$). GDP per capita (PPP) followed the same pattern falling from 5.324$ in 1990 to 3.476$ in 1995, so fell by 35% too. The cumulative industrial recession lasted six years (1989-1995) and was as high as 35%, according to WB (2002).[71] The significance of fall can be strengthened by the fact that in 1992 the value added of industrial production (constant 2000 US$) was the highest in Belarus (among all others five economies). The reason behind that is the year of the transition start – in case of Belarus it was 1992. Unemployment rate, on the other hand, has experienced the ∩-shape development: in six years it grew 4 times and then decreased slightly. In 1992 it constituted 1% of the labor force, in 1996 it was already 4%, in 1998 it decreased to 2%, and since 2001 it started to grow slightly. In should be kept in mind that the correctness of the official statistics of Belarus is highly disputable.

Croatia's development was different: the recovery took more than three times more time. The regime changed in 1991 and the transition started in 1992. The GDP was falling swiftly. Its level was the lowest in 1992-1993 (14.981 and 14.587 billion US$ respectively compared to 21.503 billion US$ in 1990), undoubtedly the result of the civil crisis. So the cumulative recession was of the 35% level. The full recovery (growth higher than at the beginning of transition) came in 2004, basically it lasted 11 years. Annually, the growth was not higher than 10%. 1998-1999 were the years of the growth slowdown; however, since 2000 the growth is constant. GDP per capita fell from 4.499$ (1990) to 2.970$ (1993), so declined by 34%, as well

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[66] See Figures 2.2 and 2.3 pp. 96-97
[67] Havrylyshyn, O. (2006) pp. 160
[68] See Figure 2.4 pp. 98
[69] See Figure 2.5 pp. 99
[70] See Figure 2.6 and 2.7 pp. 101-102
[71] The WB: "*Transition. The First Ten Years*" (2002) pp. 5

as the GDP per capita in PPP (from 10.079$ in 1990 to 6.675$ in 1993). The level was fully restored in 2002. Industrial production was falling with the most rapid rate in comparison to the ones of other five states. The cumulative years of the decline accounted for 4, with the total decrease of 36%. The recovery is rather flat: the annual growth rate does not exceed 5%. Croatian labor force experienced probably the most dramatic development. The annual growth of unemployment rate was extreme: from 8% (of labor force) in 1990 to 15% in 1992. Until 1995 the rate stood constant at 15%. In 1996 it fell sharply to 10%, but since 1998 grew again to 16% (2000). Since then it is slightly decreasing.

Czech Republic started the transition in 1991 and it took only a month to start stabilization, according to Havrylyshyn (2006).[72] It seems that Czech Republic was the first to recover from transformational recession. GDP fell visibly during first years of transition, from 54.397 billion (constant US$) in 1990 to 47.833 billion in 1992. In 1993 GDP started to grow moderately. In 1996 it reached the level of 1990. Then there was a slight decline starting in 1997. But since 2000 the growth is stable and dynamic: in 2004 GDP level was 15% above the pre-transition level (62.612 billion US$). GDP per capita fell by 22% (from 5.249$ in 1990 to 4.633$ in 1993), in terms of Purchasing Power Parity the recession was minimal – it started to increase already in 1994 and by 2004 reached 6.148$. The evolution of industrial production was unstable. Recession took 3 years and the cumulative decline amounted for 12%. The negative growth occurred already in the first year of transition: in 1991 the level decreased by 30%. In 1992 it slightly slowed down to 20%, in 1993 however grew to 30% again. Since then the value added in industrial production grew until 1996, the growth was rather flat, annually it did not exceed 5%. Then it declined again in 1998 and grew moderately. The stable growth started in 2001, and in 2004 it almost reached the level of 1990. Unemployment, on the other hand, did not grow significantly at the beginning of the process; in contrast it was rather low in comparison to other countries: from 1% unemployment in 1990 it increased to 3% in 1992 and 4% since 1994. However in 1996 it started to increase dramatically, reaching 9% in 1999. Since 1999 it started to decline, however, the rate in 2002 (7% of the labor force) is seven times higher than in 1990.

Notwithstanding the fact that Estonia became a member of the EU together with Czech Republic, its transitional recession was much stronger in this country. The stabilization was launched in 1992, after 10 months of the start of transition. The fall was rapid in 1990-1992 (falling by almost 30% of the 1990's level), but factually it continued until 1994. Since 1995 it started to increase and in 1998 it was 15% lower than in 1990 (5.069 billion US$ in contrast to 5.942 billion at the beginning of transition). Since 1999 Estonian GDP grew constantly and reached the level of 1990 in 2001. The annual growth rates were not exceeding 5%. The

[72] Havrylyshyn, O. (2006) pp. 160

recession is visible also from data on GDP per capita: it moved from 3.787$ in 1990 to 2.714$ in 1993, so totally decreased by 30%. GDP per capita in PPP followed the same trend – it fell from 8.940$ (1990) to 6.459$ (1993); however recovered fully by 2000. Industrial production suffered a U-shape development, and the recovery was almost 3 times longer than the recession. Its annual value added fell rapidly in 1990-1994, causing 35% decline (from 1.988 billion constant US$ in 1990 to 930 billion in 1994). The recovery was slow but stable. Annual growth rates did not exceed 5%. There was a small negative growth in 1998-1999, but since then the growth was stable. In 2004 it almost reached the level of 1990 (1.834 billion US$). The growth in unemployment was more significant. Between 1990 and 2000 it grew almost 14 times (from 1% of labor force in 1990 to 14% in 2000). In 1995-1998 the unemployment rate was constant at 10%, but since 1998 it annually increased with 10% rate to 14%-level (in 2000). In 2001 however the rate fell to 13% and in 2002 to 10%.

Kazakhstan, as a country of the former USSR has experienced development similar to the one of Belarus and Russia. It started the transition 1992, but stabilization occurred only in 1994, after 38 months. The decline lasted until 1998, and totally GDP fell by 41%. It was one of the longest recessions throughout the region. The decline developed rapidly, with more than 5% rate annually. In 1998 it was the lowest (16.221 billion US$ compared to 26.348 billion in 1990). GDP started to grow actually since 1999, and the rate was surprisingly high (almost 10% annually). The growth was higher than in other five analyzed. In 2003 Kazakhstan's GDP reached the 1990 level (so fully recovered). GDP per capita has experienced a dramatic decline. It fell by 40% (from 1.612$ in 1990 to 1.007$ in 1995).GDP per capita in PPP followed the same pattern: it was as high as 5.716$ in 1990, and decreased to 3.603$ in 1995. In 2003 it reached the level of 1990. The value added of industrial production was not that successful in recovery. The decline lasted 6 years. By 1995 industrial production level fell by 40% (from 15.495 billion constant US$ in 1990 to 5.496 billion in 1996). It seems that Kazakhstan's recession was the deepest in comparison to other five countries. In 1995-1998 the value added was constantly 40% below the level of 1990. Since 1999 it started to increase with the annual rate equaling 5% on average. By 2004 the level of industrial production was still 30% below the level of 1990. Simultaneously, unemployment started to grow in 1992 and accounted for 2% of labor force in 1995. However in 1996 it increased sharply to 4% and stayed at that level until 2000. Since 2001 it decreased to 3% and continued to be constant at that position. As in Belarus case, the level is surprisingly low.

Finally, Russian performance was probably the most dramatic. Officially it entered transition in 1992 and reforms were launched after 2 months. However, the decline was sweeping and reached the lowest point in 1998, GDP fell by almost 45% (from 385.895 billion

US$ in 1990 to 221.897 billion in 1998). The recession was rapid in 1990-1995, and accounted for 35% decline. In 1995-1998 additional 10% was experienced. It lasted 7 years in total (only Ukraine and Turkmenistan had the longer output fall). Since 2000 GDP started to grow (with roughly 5% annual increase in growth). According to *World Development Indicators* database, Russia needs additional 15-20% growth in order to reach the level of GDP in 1990.[73] Russian GDP per capita has decreased from 2.602$ in 1990 to 1.511$ in 1998, so the cumulative decline was as high as 52%. In terms of PPP the picture is the same (the fall from 10.087$ (1990) to 6.109$ (1998) has caused a 40% decrease). The decline in industrial productivity was dramatically U-shaped. During 7 years it fell by 40%, according to WB (2002). By 1996, value added by this sector was as low as 74.914 billion US$ (constant, 2000), in comparison to 164.481 billion in 1990. Since 1995 it was rather stable, however did not react negatively to the financial crisis of 1998. Moreover, since 1998 it started to grow with a moderate rate. Since 2000 the growth became more swift and stable. By 2003 it was still 30% below the level of 1990. At the same time the growth of unemployment was one of the biggest in the region. In 1992 it was already 5% of the labor force, in 1994 it was 8%, and in 1995 in jumped to 10%. Not decreasing at all, it grew to 13% in 1998 and 1999. The decrease started only in 2000: the rate started to fall slowly and in 2002 accounted for 9% of the labor force.

2. 2. 2. Impact on individuals (social indicators)

Numerous studies exist focusing on the growing social inequality, increased poverty, and declining life-expectancy in the region. The most frequent conclusions were expressed by Grun and Klassen (2001): "...Due to low inequality and moderate income levels, socialist countries enjoyed relatively high levels of economic well-being... In the transition, rising inequality and falling incomes have led to a dramatic absolute decline in well-being".[74]

The overall well-being can be measured by Human Development Index by the *United Nations Development Programme* (alternatively to GDP). However the weaknesses of this synthetic construct (survey coverage, poverty definition, comparability across countries, etc.) should be kept in mind. Anyway, HDI measures the average achievements in a country in three basic dimensions of human development: a long and healthy life (as measured by life expectancy at birth); knowledge (as measured by the adult literacy rate and the combined primary, secondary, and tertiary gross enrolment ratio); and a decent standard of living (as measured by GDP per capita at PPP in USD$). Thus, it reflects not just social conditions but a combination of social and economic ones, thus it can be a broader measure of well-being. The average results

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[73] *World Development Indicators* database

[74] Grun, C. and S. Klasen (2001) pp. 362

are presented by Havrylyshyn (2006).[75] For the Central Europe he concludes that the average HDI shows no decline even in the first half of the decade. Within the group only Croatia shows a slight deterioration in 1990-1995 (from 0,801 to 0,794) which may not be surprising given the post-Yugoslav conflict environment. Czech Republic result in 2003 is 0,874 (31 place), and it is the best result among the countries of this analysis.[76] A strong deterioration is undeniable in the Baltics, author continues; however by 2001 all three had surpassed the initial HDI level (1990). Estonia's position in 2003 was 38th (0,853), just after Chile. By the way all these values are still in the range of the UNDP Report's category of *'High Human Development'*. As of CIS countries, they developed differently. Late reformers (including Belarus) seem to avoid the worst of deterioration: the decline of HDI to 1995 was clearly much less for the slow-reformers than for the rapid reformers as Russia and Kazakhstan). The question is whether late reformers really coped with social costs or just postponed their appearance. But all of them declined significantly, from the 'High Human Development' category down to the 'Medium Human Development'. In 2003 Russia's place was only 62nd (0,795), Belarus was 67th (0,786), and Kazakhstan stood 80th (0,761).

Life-expectancy and gross educational enrolment ratio can be analyzed separately. The trends demonstrate again that the Central Europe, and to a minor extent SEE and Baltics either avoided all together any deterioration of health standards or experienced a relatively minor decline that was fully recovered, for example a 4% increase in 13 years in the Czech Republic (from 71 in 1990 to 75 in 2003).[77] Gross educational enrolment ratios in Central Europe were on average 71% in 1990, 72% in 1995, and 78% in 2001.[78] Baltics performed slower at the beginning but faster more recently: 70% in 1990, 71% in 1995, 86% in 2001. Even South-Eastern Europe (in several cases thorn by civil war) shows a positive development (even though it is U-shaped): 66% in 1990, 64% in 1995, and 67% in 2001.

CIS countries in contrast are in a much worse situation. Total life-expectancy at birth ratio has deteriorated in all three countries of our focus. In Russia, the level fell from 69% (1990) to 66% (2003); Belarusian and Kazakhstan's developments were similar: from 71% to 68% in the former case and from 68% to 61% for the latter case. As of the quality of education, CIS states again have nothing to be proud of. On average, the gross educational enrolment ratios in CIS countries decreased from 66% in 1990 to 60% in 1995 – 6% is significant enough. Then at the stage of recession the level started to grow very slowly, increasing only to 62% during the six following years.

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[75] Havrylyshyn, O. (2006) pp. 94-95
[76] See Figure 2.5 pp. 99
[77] *World Development Indicators* database
[78] Havrylyshyn, O. (2006) pp. 114

Estimation should be also made on the distributional impact of transition, since it was undoubtedly more severe. Due to the sharp lack of unbiased data the most reflective method is the analysis of GINI coefficient development. The analysis however seems to come to a dead end: the sources propose too diverse results. WDI database, for example, says that it was 0.30 for Belarus (2000), 0.29 for Croatia (2001), 0.25 for the Czech Republic (1996), 0.37 for Estonia (2000), 0.32 for Kazakhstan (2003), and 0.31 for Russia (2002). Havrylyshyn (2006), on the other hand says that in pre-transition period Russia ranged from 0.22 in one estimate for 1989 to 0.45 in another for 1992; in Central Europe an estimate for Croatia shows a value of 0.36 much beyond the range for the others in the group, 0.19 to 0.28. At the end of the period, he continues, Russia is in one study as high as 0.49, again an outlier, with the rest ranging 0.29-0.41.[79] So, author comes to several important conclusions. First, the wide variation strongly signals the need for caution in drawing any conclusions. Secondly, despite the dispersion it is evident that the GINI values rise in all countries and this rise (in available estimated values) is distinctly greater in CIS countries with Russia an evident outlier on a high side. Author's third and most important conclusion is that "...There is a strong hint for at least some CIS countries that the first big jump occurred in the first two or three years of the 1990s, that is before transition in any meaningful sense could have had much impact".[80]

Few words should be said about poverty ratios (percent of population below the poverty line). Using a synthesis of different estimates successfully combined in Havrylyshyn, it is possible to compare the developments.[81] Czech Republic went through 1% (pre-transition) – 1% (mid-transition) – 2% (most recent) poverty ratio. Estonia was less successful: 1% - 40% - 5% (respectively). The situation was more severe in CIS states. Kazakhstan suffered 5% - 50% - 15% poverty ratio evolution. Russia's results were 12% - 50% - 24%. The situation in Belarus actually does not improve significantly with time: 1% - 47% - 42%. There are no data on the Croatian poverty ratios unfortunately.

What conclusions can be drawn out of the official data of WB and IMF? Transformational recession was undoubtedly experienced by all six economies; and the successful recovery was not guaranteed. It seems that the European countries are not of the same development: the Czech Republic is probably the only state that had a small decrease of overall economic performance and a quick recovery (thus followed the prediction of Western analysts). In contrast Estonia and Croatia were not that successful neither in coping with negative consequences of the decline or in speed of the recovery, notwithstanding the EU assistance (in case of Estonia) and booming ship construction industry (in case of Croatia). Anyway the

[79] Havrylyshyn, O. (2006) pp. 98
[80] Havrylyshyn, O. (2006) pp. 99
[81] If there are several possibilities, the highest estimates are used

developments in the CIS countries are much worse. Belarus, Kazakhstan, and Russia have suffered a deep recession (35-45% decline on average). The rapid decline was, however, complemented by the rapid recovery. Generally, it should be kept in mind that GDP growth rates are now higher in CIS countries in comparison to CSB states. Even though the GDP level of 1990 was reached by the majority of countries (excluding Russia), the trends in industrial production are rather drastic for all six countries. Actually, only Belarus was able to reach the level of 1990's industrial value added. As of the unemployment, during the first five years of transition it grew throughout the region. Even Belarusian unemployment rate (the lowest among the six countries) increased almost 4 times. As of the Europe, the trends in unemployment are not positive: once increased, the unemployment rate stays on that level and in future only increases in cases of Czech Republic, Estonia, and Croatia. In CIS group only Russia has a high unemployment rate; both Belarus and Kazakhstan are able to fix it at 3-4% of the labor force.

It is evident that evolution of social conditions strongly supports the idea that there were significant differences in performance throughout the region. The diversity in depth and speed of transitional impact on the output and unemployment is undoubtedly connected to the social costs of transition. A sharp tendency becomes visible: the rapid reformers were generally more successful not only in terms of macroeconomic performance, but also in terms of coping with the social costs of transition, as poverty and income inequality. However, the success was achieved not only due to the choice of strategy. Russia, being also a rapid reforming economy still suffered great decreases in levels of output, employment, and also in terms of social indicators as life-expectancy and education enrolment ratios. Similarly Belarus, extremely slow in market reforms implementation does not demonstrate the big decline in industrial production and employment; however, the position is weakened significantly by the growing social costs.

Several questions arise then. What were the reasons of the divergent developments throughout the region? More specifically, what factors determined the depth and length of transitional recession and what factors determined the faster recovery? Finally, it is worth thinking if there is a scenario under which the countries could in future converge in their economic performance and the level of well-being. The second part of the work will try to answer these questions.

3. Search for explanation of divergent developments

"The process of transformation involves so many dimensions of the economy, polity and societal relations that one is easily tempted to conclude no simple systematic explanation of the process is possible because each country has a set of unique features which influenced the decisions and choices made…".[82] Havrylyshyn is practically right in his statement, because there are so many specific factors influencing every country and every nation that their classification turns out to be a hard task. Still, the framework can be developed if some generalization would be allowed. The explanation of the differences in performance can be done through various methods. The most common approach is probably a case study method – a detailed analysis of a single country or perhaps a small number of countries in a comparative analysis, as in Reddaway and Glinski (2001), Shen (1996), Kolodko (2000), etc. Another way is to supplement the cross-country quantitative studies with a large number of characteristics of each country and allow the statistical analysis telling the story by itself. The econometric analysis frequently concludes that the major factors determining growth in transition are initial conditions and policy-choice variables, as for example in the fundamental work of De Melo (1997). Also, probably the most 'sage' approach is the collection of all possible factors which can be found in transition literature. Havrylyshyn calls it 'Encyclopedic Approach'. Basically, initial conditions matter in terms of: natural resources, years under communism, level of per capita income, share of industry, concentration of heavy/military industry, war/civil conflict, continuity of old elites, type of first government, and many others. The same tendency works for the role of the policies implemented (gradual or big-bang; year of stabilization start; effectiveness of rule-of-law; TPI value reached by year *t*; share of private sector by year *t*; frequency of governmental change; degree of democracy; etc.)

Basically, there is no consensus among economists on the factors determining the development during transition. For example Kekic (1996) takes a radical position hypothesizing that the main determinants of differences in performance between different countries in transition may be actually external to the approach to transition itself. He focuses on three main factors: initial situation in the transforming countries (as measured by composite index reflecting the pre-transition foreign trade orientation, external debt situation, level of GDP per capita, structure of economy in terms of industry and services, energy intensity of the economy, etc.); political cohesion, and inflows of official medium-term funds and official grants. Kekic (1996) found out that "…Regressions, in a variety of specifications, show that initial conditions, official foreign inflows and a dummy variable for countries engaged in civil thrive accounted for two thirds of the cross-country variation in output performance in 1989-1995 (for the 11 countries of

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[82] Havrylyshyn, O. (2006) pp. 125

eastern Europe alone almost 90 percent of the variation)... Our findings on the influence of institutional reform are at variance with optimistic assessment of the impact of rapid change... No specifications yield a positive impact. The most robust results in fact suggested a negative impact of the extent of institutional change, once other factors were taken into account, although the level of statistical significance was low..."[83] However, the Kekic's analysis is able to explain the majority of cross-country variations in performance in terms of specific variables, it still fails to explain why Estonia, for instance, has done as well as it had. Consequently, the Kekic model strongly proves that policy/institutional factor (and probably others too) have been important.

On the other hand Dyker (2004) comes to the conclusion that the variation in economic performance can be explained in terms of investment (aggregate investment and foreign direct investment) and differences in policy stances vis-à-vis monopoly and competition as a secondary factor.[84] He believes that Kekic's analysis helps to redefine microeconomic analysis: "... It is surely significant that the countries which are strongest on initial conditions are among those strongest on small and medium size enterprises development and monopoly/competition policy".[85] So, one important conclusion can be drawn from both approaches described: there is a great danger of concentrating on very narrowly specified variables.

So, the major attention is paid to the role of initial conditions and policies implemented in the scientific literature. However, due to the inconsistencies within both factors it seems natural to take into consideration other frameworks. This comprehensive approach allows to understand the situation more correctly (in this perspective the more ones knows the better); and, what is more important, helps understanding the outliers in the systemic cross country analysis. However, it has some weaknesses, mainly because it is too broad. When it comes to comparative analysis across countries, the use of a comprehensive approach produces so many factors (that allow numerous permutations), that it becomes difficult to follow the line of logic and almost impossible to find some common factors. There is a danger of seeing each country so narrowly that it appears to be unique (either good-positioned or bad-positioned in the historical transformation and so unable to follow the same path of transformation).

Moreover, it often happens that the same factor has opposite effects in different countries or over time, or an advantage works well in one country and does not work in another country. This point has been emotionally described by Bunce (1999): "...There are varieties of factors that are while logical and suggestive, do not seem to provide a robust explanation... For example, while all the stable and fully democratic cases are by regional comparative standards [both rich and ethnically homogeneity factors] some relatively rich states score low on both

[83] Kekic, L. (1996) pp. 9
[84] Dyker, D. A. (2004) pp. 316
[85] Dyker, D. A. (2004) pp. 318

democratization and political stability (Slovakia, Croatia, Ukraine) and some homogeneous states do the same (Albania, Armenia)...Moreover, state age is not all that helpful factor, given the inclusion of Slovenia and the Czech Republic in the group of stable and fully democratic orders... Finally, such factors as religion, imperial lineage (or inclusion in the Habsburg versus the Russian or Ottoman empires), and institutional designs (parliamentary government versus forms of presidentialism) do not seem to account all that well for these differences".[86]

The current analysis is divided into main perspectives. The first will be addressed to the impact of initial conditions on the economic performance and the role of the transition policies and the process of institution-building (comprehensive approach), since they are the most common determinants of transitional performance in literature, and are supplemented by valuable analysis upheld. However, other factors are taken into consideration too, namely the Transition model by Havrylyshyn (2006). His alternative parsimonious approach considered instead the effects of the intensity of the political debate, rent-seeking (focusing on the effects of state capture) and the role of external economic framework (focusing mainly on international organizations membership and external assistance). This perspective, I believe, is able to fill the gaps in explanation power of the comprehensive approach.

3. 1. Role of the initial conditions

The role of initial conditions was examined in Berg, Borensztein, Sahay, and Zettelmeyer (1999), Havrylyshyn and van Rooden (2001) and others. In terms of development, resources and growth initial conditions were most comprehensively classified in the fundamental work of De Melo, Denizer, Gelb, and Tenev (1997).[87] They start their analysis with a look at the income levels, measured in 1989 US$ but reflecting purchasing power parity income in the base year. Under their estimations, Slovenia had the highest amount ($9200) and China the lowest ($900). Unfortunately these countries are out of the scope of the work, but still interesting results come out of the comparison of the Czech Republic, Croatia, Estonia, Belarus, Russia and Kazakhstan. Table 3.1 illustrates the findings.[88] Per capita income was the lowest in Kazakhstan ($5130), then Croatia followed ($6171), Belarus was the third with $7010, then stood Russia ($7720), the Czech Republic ($8600), and finally Estonia had the highest per capita income ($8900). As we can see, the general idea that the particular members of the USSR were undoubtedly poorer in this perspective than the satellites of the USSR in the Central and South-Eastern Europe (not the members) can be challenged. The social indicators roughly followed the income levels.

[86] Bunce, V. (1999) pp. 779
[87] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 9-16
[88] See Table 3.1 pp. 106

The second initial condition that is crucial for growth in transition is urbanization. Its cross-country distribution closely mirrors the tendency of lower income countries being on average more rural. In 1990 urban population constituted 74% in Russia (the highest result in the whole region), 72% in Estonia, 66% in Belarus, 65% in the Czech Republic, 62% in Croatia, and 57% in Kazakhstan. So it can be said that the core of the differences lies not in belongingness to the Union or not (or in the years under communism), but falls under the general difference between urbanization levels in Europe and Asia.[89]

Level of industrialization was another condition for positive development transition, measured as a difference between the actual share of industry in GDP and the share predicted in Chenery and Syrquin (1989). In 1990, the industry sector accounted for 35% in Croatia (the second after service sector – 55%), 58% in the Czech Republic (service sector accounts for 35%), 49% in Belarus (compared to 29% of service sector), 44% in Estonia (service sector equals 36%), 34% in Kazakhstan (compared to 37% service sector), and 48% in Russia (service sector equals 37%). Authors believe that over-industrialization was common in USSR members: "... Industrial shares were often high because trade, financial services, and business and consumer services were typically repressed in socialist countries...In 1989, only Hungary, Slovenia and Croatia had service shares of 50% of GDP, a typical level for upper middle-income countries... Czechoslovakia had industrial shares of over 50% of GDP... Russia and countries in the north-eastern part of the FSU were close to this level".[90] Ahrend (1999) believes that: "The initial structure of output comes out less strong than we expected... A larger share of agriculture had a negative (but only for GDP growth significant) effect; industrial production came out positive, but again not always significantly...Contrary to the expectations, regions with a higher initial share of services did not perform better that the average [in the case of Russia]... A possible explanation for this might be that a large initial "soviet" services sector could have been an obstacle to the creation of a new, more productive private service sector".[91]

Other very important factors are the geographical location of the country and the richness of natural resources. The location, defined as geographical proximity to thriving market economies is important because it facilitates the import of market institutions and the adjustment of trade patterns. Simultaneously, the richness in terms of natural resources may (at the first sign) stipulate the transition, but not necessarily. For example, countries profit from good economic performance of neighboring countries, and countries with easy access to major routes for international transport perform better. Translating it into regional economics, it seems that regions with permanent sea access or major ports perform better.

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[89] Many countries of the Central and East Asia have urbanization levels under 50%
[90] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 10
[91] Ahrend, R. (1999) pp. 6

However, the findings of Ahrend (1999) imply some restrictions to the effect of good location: "...We actually find that geographic location has some impact, nevertheless not exactly always the way we would have expected... Whereas regions with a port did – at least in GDP growth – significantly better, permanent access to sea comes out insignificant...Saint Petersburg [for example] did not have a growth performance above average, in spite of being a port, a large city, and being located in a rather well performing part of Russia" [92]. Author's conclusion actually points to the weaknesses of focusing on the single variable. Looking at borders, Ahrend (1999) comes to more controversial conclusion: "... [We] find that they [borders] have had little significance, and where they had, rather in an unexpected way... Russian borders with Ukraine and Belarus seem to have done rather well in terms of real income growth... [But] closeness to Baltic or EU countries has not had any effect so far... Latitude or Longitude is largely insignificant, as well as being a region in the European part". These conclusions are somehow disputable, since the majority of authors believe that the distance from Brussel or Frankfurt plays a significant role for the transition destination.[93]

A larger natural resource endowment (and especially production of oil and gas) explaining a better economic performance in Russia is described in Ahrend (1999): "...It is somewhat surprising to see that mining regions did not under perform the general average, taking into account all the negative media coverage about these places".[94]

The conclusion is that these two variables are interdependent, and both factors should be analyzed together. For instance, the resource rich Kazakhstan had to cope with logistical problems prior to realization of its oil and gas potential, also iron and steel, zinc, copper, titanium, gold, etc. So the benefit out of the rich natural resource base is affected by the inefficient location (far from prosperous Western markets and with poor logistics). Russia in this sense was more successful, since it experienced both beneficial geographical position ('a bridge between west and east') and a big reserve of various natural resources (oil, gas, coal, timber, minerals, gold, diamonds, fuels, etc.). However, again the problem of logistics arises - the majority of these resources are located in remote and climatically unfavorable areas that are difficult to develop and far from Russian ports. But the access to eleven seas seems to have a visible impact on Russian growth. Belarus is neither well-positioned nor equipped with a natural resource base, according to De Melo, et al. (1997).[95] It actually has the deposits of peat (mineral resource used for fuel and fertilizer and in the chemical industry), clay, sand, chalk, dolomite, but they are not prevailing in the country's export (in comparison to agriculture machinery and

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[92] Ahrend, R. (1999) pp. 7
[93] Havrylyshyn, O. (2006) pp. 126
[94] Ahrend, R. (1999) pp. 6
[95] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 53

textile industries). The location can be also beneficial (even though land-locked), since it belongs to Eastern Europe and could be an active transit country between Russia and the European Union.

Croatia, on the other hand, is poor in terms of natural resources reserves (only moderate deposits of natural gas and cruel oil) but benefits from the good location (access to the sea and relatively close distance from the EU member states). The Czech Republic follows the trend: only coal, timber, lignite, uranium, and magnesite as natural resources are not assumed to have a very big impact on the growth in transition. But the Czech location is so beneficial that it became a member of the EU in 2004. It has a developed logistics, and foreign transit brings profit to the country. Estonia is this sense is very similar: its natural resources are rather poor (only oil shale energy, fishing, and timber). However, the location is beneficial. It is a particular member of the EU, besides; its ice-free port of Muuga is a modern facility featuring good transshipment capability and a brand-new oil tanker off-loading capabilities. The railroad, privatized by an international consortium in 2000, serves as a conduit between the West, Russia, and other points to the East.

At the same time, Hare (2001) points out, that countries with abundant natural resources can generally expect lower growth rates, other conditions being the same. The most obvious reasons are: (a) large natural resource exports can push up the equilibrium exchange rate, making much of the rest of the economy internationally uncompetitive (so-called 'Dutch disease'); (b) incomes earned in the resource sectors may not be taxed adequately to spread the benefits across the whole economy (firms in the resources business may establish strong lobbies, for instance), so domestic demand for goods and services can then be very weak due to the low incomes; and (c) the resulting incentives for the new firms to enter non-resource sectors can be weak at best.[96]

The indicator of economic conditions dominating in the post-Socialist countries prior to transition is the rate of the growth in the socialist period. Lavigne (1999) describes the crisis in the socialist countries in the 1970s and 1980s.[97] Since 1950 the growth steadily decelerated, bouncing up a little in 1966-1970 due to the initial impact of the reforms. The shift towards 'intensification' did not slow the deceleration. On the contrary, the trend toward an absolute decline of the Net Material Product increased in the years just preceding the fall of communism.[98] Taking the inefficiency of the planned economy into account, was this trend also due to the impact of the Western economic recession following the first oil shock of 1973? This idea was very popular in 1970-1980s; it was explained in Neuberger and Tyson (1980), for example.

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[96] Hare, P. G. (2001) pp. 18-19
[97] Lavigne, M. (1999) pp. 57-60
[98] See Table 3.2 for definition pp. 107

They believed that this explanation was certainly true for the countries of the Eastern Europe, which were hit by the deterioration of their terms of trade with the West, the increase of their trade deficits and the surge of their indebtedness in convertible currencies.[99] USSR, on the other hand, benefited from the increase in the world oil prices (consequently, the incomes of the oil-exporting countries of the USSR increased, and the arms trade increased) and the in the increase of the price of gold. According to De Melo, Denizer, Gelb and Tenev (1997), the average growth tended to be higher in the poorer countries (in our case Russia with 3.2% growth in 1985-1989, Kazakhstan grew at 4.3% rate, growth of Belarus amounted for 5.2%). Central Europe, Baltics and South-East Europe had much smaller growth rates in 1985-1989: the Czech Republic grew at 1.6% rate, Croatia had 0.2% growth, and Estonia had 2.7% growth rate.[100] The reason for such tendency lies, according to the authors, in the position of the country within the Socialist system: "...It has been observed that growth in the earlier stages of socialist accumulation is higher and countries found themselves at different stages of this process at the beginning of transition... The more mature countries were experiencing stagnation (if not declining growth), whereas poorer countries were still benefiting from higher growth".[101] It can be also said that those countries that were in the core of the USSR economic system (so were the essential parts of the socialist mechanism), were still benefiting from the Union more that the satellite countries of the CEE (Yugoslavia is this sense should not be considered at all, however, in 1985-1989 its growth was almost zero as well, indicating the domestic inefficiencies and disruptions of trade links with the USSR and its satellites).

Analyzing the reason for the economic recession in the USSR, Easterly and Fisher (1994) came to the conclusion that "...Our results confirm and update the results of Weitzman (1970) on the low Soviet elasticity of substitution between capital and labor, which combined with the Soviet attempt at extensive growth, is sufficient to explain the decline..."[102]

The variable reflecting initial economic distortion is probably the level of inflation. Authors believe that open inflation was chronic only in the former Yugoslavia republics and in Poland in 1989, but the repressed inflation was high in most CEE and FSU.[103] They suggest that the weakest inflationary pressures were in Czechoslovakia. During 1980-90, repressed inflation was insignificant, the demand for money was mostly for transaction purposes, and inflationary expectations were almost myopic, according to Feltenstein and Ha (1993).[104] The level of repressed inflation between 1987 and 1990 was -7.1% in the Czech Republic. But on the other

[99] Neuberger, E., Tyson L. (1980) pp. 13
[100] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 53
[101] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 12
[102] Easterly, W., Fisher, S. (1994) pp. 22
[103] The indicator of repressed inflation is the increase in deflated wages minus the change in real GDP (1987-1990)
[104] Feltenstein A. and J. Ha (1993) pp. 2

side of the spectrum there were FSU and CEE countries with the higher repressed inflation (where upward pressures on prices mounted after 1987, propelled by glasnost and diminishing Union control over the Republics).

Repressed inflation between 1987 and 1990 was 12% in Croatia, and all the countries of FSU (including Estonia, Russia, Belarus and Kazakhstan) had the rate of 25.7%. In 1993, the level of inflation in consumer prices was 1190% in Belarus, 1500% in Croatia, 90% in Estonia, and 895% in Russia.[105]

The trade shares in GDP were high in most CEE and FSU countries and trade flows were concentrated within the Council for Mutual Economic Assistance area, reflecting the desire of soviet authorities to create a regionally interdependent communist economy. Trade flows within the area were especially large for the smaller republics of the USSR, while trade outside the area was rather small. CEE countries were less dependent on CMEA trade than FSU. Actually, in 1990 the trade dependence (defined as a ratio between the average of exports and imports and GDP) was 6% for both Croatia and the Czech Republic; it was as big as 11.1% in Russia; 20.8% trade dependence was experienced by Kazakhstan; 30.2% level was in Estonia; and, finally, 41% in Belarus. The breakdown of the CMEA and the collapse of the USSR therefore caused serious disruption in the international trade and payments of these countries. Few words should be said about CMEA.

It was originated in 1949 as a response to Western Marshall Plan. In 1970s and 1980s the idea that the organization served Soviet interests while being disadvantageous to Central and Eastern Europe. As of the profitability of the organization, the comprehensive econometric study of Marrese and Vanous (1983) showed that the particular pattern of Soviet export and import prices with the CMEA led to substantial losses for the Soviet Union in terms of forgone gains from trade with the West. The study also showed that such losses were a permanent feature of Soviet trade with the CMEA and had only been exacerbated after the rise in world oil prices. Factually, the inability of CMEA-members to participate in the Western markets seriously decreased the Eastern Europe products' quality. The 45th session of CMEA in January 1990 decided upon a quasi immediate shift to 'world prices' and settlements in hard currencies. The 46th session put an end to the organization, whose legacy however endured much longer. As of the trade between East and West, it accounted for less than 1% of the global trade (it actually concentrated on several countries of the South – 65% to 80% of international trade was addressed to Egypt, India, Iraq, Iran and Libya), according to Lavigne (1999).[106] So, CEE countries seem to suffer less from the economic disruption than FSU countries. The negative

[105] *World Development Indicators* database
[106] Lavigne, M. (1999) pp. 79-80

impact however could be at least partially compensated by the profitable location, because some countries could benefit from cross-border trade with rich countries, and in this sense Estonia suffered less than, for example, Kazakhstan (notwithstanding the fact that both were members of the Soviet Union).

A final economic distortion challenging further growth is, according to De Melo, Denizer, Gelb and Tenev (1997), black market exchange rate premium (reflecting the diversion of resources from the official to informal sector, a process often associated with consumption of real resources in unproductive activities). Black market premia were especially high in FSU, indicating the expectations of depreciation and/or foreign exchange rationing. Its level in 1990 was 1828% for all FSU countries. The level of black market premium (differential between the official and the free exchange rate) was rather high in the Czech Republic in terms of international standards (185%), but it was relatively low in comparison with other transition countries. Only Croatia had it as small as 27%, but the data seems to be underestimated.[107]

Initial institutional characteristics seem to have an impact on the development during transition. Authors believe that two particular dimensions are primary. The first is a categorical variable differentiating among countries that were either independent prior to 1989 (value 2 in Table 3.1 for "State" variable); or members of decentralized states like the former Yugoslav republics, some CEE states, and a core countries of centralized federal states like the USSR (value 1); or the new nation states (value 0). These last needed to build national institutions, including systems of democratic representation, justice, security as well as economic institutions like Central bank or customs bureau. "...Particularly, the non-Baltic FSU countries lacked national institutions... Until recently, these former Soviet republics were territories in a highly centralized political union, characterized also by a brain drain from the periphery to the center... New national states arising from the former Yugoslavia and former Czechoslovakia were not faced with such serious problems, as the federal systems in these countries gave substantial powers and responsibilities to the constituent republics... Furthermore, the historical ties and the political affiliation of CEE countries with Western Europe have given them a clear sense of direction lacked by the new nation states of the FSU".[108]

The second institutional variable is the 'market memory'. It captures the lack of familiarity of the non-Baltic FSU states with market institutions. Actually, the variable could be extremely important if the issue is analyzed under the assumption that transition is a process of large scale institutional change. While it is strongly connected to the previous indicator, it is likely to have a separate influence on the reform process, particularly on the ability of societies

[107] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 53
[108] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 15

to deal with the disequilibria of the transition. Actually, the country not having a single generation experiencing the market economy and the 'rules of the game' could provide a basis for adoption of slow and unmotivated approach to reforms or for reverting repeatedly to old ways of doing things: "...In fact, both types of reform outcomes have been observed in certain FSU countries, and policies that could be regarded as a 'clean break with the past' have been more difficult to adopt and the unwillingness of some non-Baltic FSU countries to leave the ruble zone until Russia forced them to do so, versus the Baltic countries' decision to leave ruble zone quickly could partly reflect the importance of prior experience with a market based system".[109] The number of years under central planning is used as a proxy for this variable. It is a matter of interpretation whether 70 years versus 40 years is a large difference.

Analyzing effects of the market memory, Havrylyshyn (2006) came to the conclusion that countries with 40-50 years under communism generally moved more rapidly on economic transformation, those with 70-plus years moved more slowly. The Czech Republic experienced 42 years under central planning, Croatia's socialism lasted 46 years, planned economy in Estonia lasted 51 years, in comparison to 71 years in Kazakhstan, 72 years in Belarus, and 74 years in Russia.[110] Aukucionek (1995), an author of the first comprehensive transition theory in Russia has concluded that the years under communism were directly connected to the disorientation of the agents of the new economic system. Price liberalization and free market that are natural in the transition, author says, provoke the situation in which the inefficient part of the production is eliminated (because it is not profitable to produce more products that it is demanded) and so the reduction in output appears. During this process, the depth of the decline turns out to be greater if the movement away from the market equilibrium in the typical centrally-planned industries is bigger. In other words, the longer is the period of central-planning (all other circumstances being equal), the deeper is the recession. Consequently, the severe mistakes are generated as a result of a lack of economic education. This tendency can be explained on the example of financial pyramids (so-called Ponzi schemes) extremely popular in the FSU area, while very moderate in CBS.[111] Another result is in the weak domestic corporate governance proclivity to rent-seeking and barter in turn.

Finally, the political reaction to the transition played a valuable role in the performance. As Bunce (1999) pointed out, the countries with a commitment to a vision that is fully anti-communist and hence fully liberal will move earlier and more forcefully on economic transformation is fundamentally correct.[112] It is commonly agreed that there are two forces

[109] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 15
[110] Havrylyshyn, O. (2006) pp. 160-161
[111] Aukucionek, S. (1995) pp. 61-70
[112] Bunce, V. (1999) pp. 4

behind this commitment: renunciation of communism (including the breach with its political role within the society) and pursuit of a national vision (integrating the state into global economy and the liberal, democratic assembly of nations). There is also a popular hypothesis that "the best predictor of economic reform [progress]... is the outcome of the first election".[113] At the one extreme, Estonia's first government was clearly non-communist, another extreme case is the case of slow FSU reformers, for example Belarus which is not far from fully retaining the central-planning. Bunce (1999) identifies three groups. The first group consists of clear non-communist visions in the first elections in the Czech Republic and Estonia. At the other extreme she lists countries with a clear first win of former communists - Kazakhstan and Belarus – with a strong tendency towards lack of actions. However in between the author places the cases where neither communists nor opposition won an undisputable victory and thus the path of the reform was indecisive, namely Russia and Croatia. Belarus presents an interesting case, because it had a coalition at least at the beginning of transition, where the new Chairman of the Supreme Council S. Shushkevich was probably able to launch a gradual reform; however the elections of 1994 brought A. Lukashenko to power, those politics is considered today as socialist. Havrylyshyn (2006) has classified the countries differently: non-communist governments were in the Czech Republic and Estonia, coalitions in Croatia and Belarus, and renamed communist governments in Russia and Kazakhstan.[114]

On the other hand, the national vision towards economic liberalism was diverse throughout the region at the beginning of 1990s. Again, there were extreme cases. Lieven (1993) has expressed the position of the Baltic States: "... I have often criticized Baltic nationalism, but in the post-communist world it is irreplaceable importance to providing some sot of hedge against blatant corruption and in mobilizing a sense of service and sacrifice".[115] In contrast, there are undisputable weaknesses of the nationalist thinking, which can be understood on the example of Croatia. An interesting example of how strength of nationalism led to greater commitment on economic policy is provided by Kraft (2000), who shows that the stronger the nationalism movement, the sooner it led to achieving financial stabilization.[116] Using the sample of 14 countries, six states with strong nationalism all had very early and successful stabilization (including Estonia and Croatia with an extreme case of nationalism); while the five countries with weak nationalism (including Kazakhstan) needed more time to stabilize. The possibility of negative forces in nationalism should not obscure the benefits. The point here is that in the post-communist transformation, these positive nationalist elements were for many countries an

[113] Bergloff, E., Roland G. (1997) pp. 18
[114] Havrylyshyn, O. (2006) pp. 169
[115] Lieven, A. (1993) pp. 2
[116] Kraft, E. (2000) pp. 3

integral part of the strong commitment to economic liberalism. A national desire for self-expression could only be accepted by the global community if it emulated the established nation states with a liberal democracy and open free-market economy; hence this drove much of the Central Europe and the Baltics to emulate such modern nation states. In the South East Europe and the CIS the force was less pronounced, but not totally absent. For example, Tsygankov notes that the very weak national basis in Belarus caused no changes virtually. Even in the Central Asia present the outward looking vision for the nation.[117] Gleason (1997) describes how the more 'socialist cosmopolitan' leader of Kazakhstan (President Nazarbayev) has over a decade led his country to a far more advanced state of market operations in comparison to other countries.

Can the initial conditions be summarized? De Melo, Denizer and Gelb (1997) came to the conclusion that out of the indicators mentioned above there can be summarized in their first two principal components. The first can be interpreted as measurement of macroeconomic imbalance and unfamiliarity with market processes (market distortions); the second represents the level of socialist development and its associated structural distortions (over-industrialization). Countries cluster into four broad groups. Those in the FSU all started from deep market distortions, but the Slavic countries were far more developed than those in Central Asia, and had more serious structural distortions. Countries in CEE had lesser market distortions but, being relatively more developed, had severe structural distortions. China, Vietnam, and partially Albania (so-called gradualist models of transition) formed the final group of countries with lower structural and market distortions.

Hare (2001) concluded that the Initial Conditions Index (a weighted average of indicators for level of development, trade with CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory measured by number of years of communist rule, and state capacity) was 3.5 in the Czech Republic [the highest], -0.4 in Estonia, 2.5 in Croatia, -2.5 in Kazakhstan, -1.1 in Russia and -1.1 in Belarus.[118]

Linkage between initial conditions, policies and performance is specified as an equation system in De Melo, Denizer, Gelb and Tenev (1997). Policy reform (which is represented by economic liberalization) depends on initial conditions, political change and regional tensions. Economic performance (measured in terms of growth and inflation) depends on initial conditions, economic policies and regional tensions. "... Cross-section equations suggest that initial conditions are indeed important, both for performance and the speed of economic liberalization... Belarus offers an example of a country where political change and economic

[117] Havrylyshyn, O. (2006) pp. 174-175
[118] Hare, P. G. (2001) pp. 14

liberalization proceeded relatively slowly".[119] Authors' analysis also confirms that adverse initial conditions are associated with slower economic liberalization. At the same time, "... The explanation that difficult conditions are associated with slow reforms because they diminish the effectiveness of reforms is not supported by regressions... Unfavorable initial conditions discourage reforms but effectiveness of reforms is not reduced once they are implemented".[120]

In analyzing the transitional experience of countries in Central and Eastern Europe and the former Soviet Union, De Melo, Denizer, and Gelb (1996) find strong common patterns for countries at similar stages of stabilization despite the differences in initial conditions. "Countries in CEE and the FSU differ in many respects, and their transitional experience also varies widely... Nevertheless, the analysis suggests strong common patterns for countries at similar stages of reform... [Because] the common legacy and the associated changes resulting from initial disruptions in the socialist economic coordinating mechanisms go a long way toward explaining the transition experience".[121]

At the same time, Fisher and Sahay (2004) point out that the general conclusion that the effect of initial conditions, while strong at the start of the transition, wears of over time: "...The coefficient on the initial conditions index is always insignificant... When the index is interacted with the 'time in transition' dummy, the coefficient remains insignificant but turns negative, indicating that the longer the period, the lesser the significance of the initial conditions".[122] This is not a surprising result. But the conclusion seems to be surprising in the light of cross-country growth regressions that show a persistent impact of variables such as location that are included in the initial conditions. Many of the conditions woven into the principal components are, however, themselves modified in the course of transition. Monetary overhangs are dissipated through inflation; the industrial overhang is eroded as plants shut down, and market memory returns through experience, according to the authors.[123]

The factor of initial conditions can actually explain the difference in performance in the countries. It is reasonable that the countries with a long and severe centrally-planned economic system (FSU) found themselves in a more disorganized condition than those with a strong commitment to democracy. However, the picture is still blurring. Another valuable factor determining the growth in transition is undoubtedly the process itself, namely, the creation of transition policies and establishment of institutions.

[119] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 39
[120] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 40
[121] De Melo, M., C. Denizer, A. Gelb (1996) pp. 25
[122] Fisher, S., Sahay, R. (2004) pp. 5
[123] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) pp. 41

3. 2. Role of the reforms and missing institutions

Following the standard economic consensus, regions that undertook more far reaching economic reform should have been rewarded by a better growth performance. This explanation has been expressed in the early literature on transition, for example in World Development Report (1996).[124] It stressed the degree of economic reform, as privatization, economic liberalization, and macroeconomic stabilization, in explaining the success or failure of a country. There are now many studies focusing on economic growth and performance across a much wider range of countries than the transition economies alone, seeking to explain why some countries grow rapidly while others do not. Sachs and Warner (1995), for example, focus on the question of economic convergence. Rather than pointing to increasing returns to scale as a reason for persistent divergence between rich and poor countries, authors argue instead for the importance of sound policies. They find, by performing appropriate regressions across a large number of countries, that open trading policies and effective protection of private property rights are usually sufficient to enable poorer countries to achieve higher growth rates than average. Hare (2001) has referred to Sachs and Warner (1997), pointing to the increasing role of the global integration (i.e. greater openness), higher government saving and better quality institutions, all leading to an increase of steady state income and hence boosting transitional growth rates.[125]

The reform of the economic system that occurred in Central Europe and the FSU in the 1990s has been fundamental, involving major changes of institutions, types of ownership, corporate governance, laws, modes of interpersonal behavior, and attitudes to work. Some enterprises were cut in size or closed down, others expanded or created. The institutional changes were superimposed on massive changes in relative prices and the pattern of foreign trade; the latter changes caused in their turn major shifts in the composition of output. In terms of institutions, skills, prices and products, there was therefore a large distance between the initial point (where a given post-socialist economy found itself just before the reform) and the end point of its intended transition. According to Gomulka (2000), the reform strategies have addressed the content, the sequence and the speed of reforms required to effect this transition.[126]

There is actually a debate in the scientific literature on whether effective policies are associated with higher annual growth of GDP in Central and Eastern Europe and the CIS, even when controlling for the effects of initial conditions and external economic shocks.[127] For example, some summary results of Berg, Borensztein, Sahay, and Zettelmeyer (1999) consider that most of the variability in growth is associated with differences in policies rather than initial

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[124] See *"From Plan to Market. World Development Report"* (1996)

[125] Hare, P. G. (2001) pp. 18

[126] Gomulka, S. (2000) pp. 2

[127] The WB: *"Transition. The First Ten Years"* (2002) pp. 16-17

conditions (depending on the time-declining impact of initial conditions); so the difference between CIS and Central and Eastern Europe can largely be explained by differences in policies. De Melo, Denizer, Gelb [and Tenev] (1996, 1997) estimate a model where growth (in 1992–1995) is explained by initial conditions, policy reforms (measured by the aggregate Liberalization Index), and a variable of war dummy. They find out that both initial conditions and the Liberalization Index are quite significant in the growth equation. Aslund, Boone and Simon (1996), on the other hand, find out that difference in the determinants of output changes during 1989–1995 had no significant association with policy reforms and at the end of the period the output level significantly depended on liberalization and inflation. Furthermore, Heybey and Murrell (1999) find that average growth over the first four years of transition does not depend on the increase in the Liberalization Index over the period, after accounting for possible endogenity of liberalization policies (the instruments used are the initial level of liberalization, share of industry, and an index of political freedom). The authors conclude that initial conditions are much more important than policy variables. Anyway, the role of the reforms can not be ignored.

On the other hand, the speed of reform and economic growth has been the subject of debate as well. Some economists argued for advancing reforms in all areas as fast as possible; others criticized such a strategy as imposing unnecessarily high cost. The most interesting part of the debate focuses on the sequencing of policies and the relative speed of different types of reform). Advocates of moving fast in areas amenable to rapid reform argue that the synergies among different components (for example, privatization together with liberalization of prices and trade) may generate enough gains and winners to maintain the reform momentum. The need to take advantage of windows of opportunity is also cited as important in that decision.

Not surprisingly, in conditions of a total (economic, institutional and political) crisis, virtually the only choice open for the FSU and Central Europe was a form of rapid adjustment. A strong variant of it was adopted in the Czech Republic, Estonia and later Croatia. One way of defining this scenario was formulated by Vaclav Klaus, the Prime Minister of the Czech Republic in 1993, in the shape of Ten Commandments with Four to Seven forming a core of reform efforts.[128] They were as follows:

(i) Reforms in post-communist countries are the outcome of a complex social and political process, and therefore can not be pre-planned or socially-engineered by any one person or centre;

(ii) The role of foreign aid is marginal;

(iii) An economic shock (meaning a large fall in output) is inevitable;

[128] Klaus, V. (1993) pp. 2

(iv) Dramatic actions are required to impose a restrictive macroeconomic policy, liberalize prices and foreign trade, and establish a process for privatization;

(v) A restrictive macroeconomic policy must be sustained;

(vi) The price shock resulting from the price liberalization must be vigorously defended and survived;

(vii) Economic restructuring requires comprehensive privatization;

(viii) Transformation costs must be widely shared;

(ix) Successful transformation requires the opening of markets to foreign goods and the free flow of peoples and ideas;

(x) Successful transformation requires successful politicians.

But, the strategy in the majority of FSU countries was also big-bang. However, it seems that it was much weaker than that of the CEE countries. In Russia, for example, the 1992 Gaidar's attempt of sharp budget hardening and liberalization of prices, trade and entry actually failed. Gomulka (2000) points out that "... This meant that enterprises have, subsequently, been under less pressure to divest physical assets and shed labor they did not need, thus effectively denying *de novo* private firms to resources they need for their development... The failure to liberalize thoroughly kept the set-up costs for new firms high... For several years large subsidized credits and entry barriers undermined the credibility of the strategy of the strategy, inducing capital flight, creating opportunities for tax avoidance and criminal asset stripping, as well as slowing down the restructuring by old firms... The Russian reform was nevertheless radical, since the large prices and wages were liberalized quickly".[129] As a result, markets started to develop, taking the informational and coordination roles from the planners. A large-scale privatization was also initiated early and implemented quickly. So, the implementation of privatization before full liberalization (of prices, trade and entry) and before the hardening of budget constraints for enterprises and disinflation was the key characteristic feature of the reform strategy adopted by Russia and the most other CIS countries in the first few years of transition. However, the differences between both variants (strong and weak) have narrowed down in the late 1990s.

It then seems logical categorizing countries by reform scenario implemented. As pointed out in the Chapter 1, the majority of countries in the region implemented the big-bang transition. Havrylyshyn (2006) has distinguished the countries by their reform strategies.[130] The Czech Republic, Croatia and Estonia enjoyed a wide consensus and hence experienced very limited debate, so committed to early reforms. But among them some were already more advanced and

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[129] Gomulka, S. (2000) pp. 6

[130] Havrylyshyn, O. (2006) pp. 158-159

did not move that quickly after (Type I: Advanced Start, Steady Progress, as in Croatia); while others starting farther back undertook a more rapid pace, closest to the big-bang concept (Type II: Sustained Big-Bang as in the Czech Republic and Estonia). Russia also started early and moved fast, but did not sustain the pace and should be considered as aborted big-bang cases (Type III: Big-Bang Unsustained). It was different from the clear big-bang scenario significantly, both in the extent of the change in the first years and, most importantly, in not sustaining this strategy but experiencing policy reversals and resurgence of inflation. Kazakhstan belongs to the group of gradual reformers (Type IV: Gradual, Delayed Reforms), where the start of transition was delayed for a long time and/or put on a very slow-track as a result of the extended debate. Russia can probably belong now to this category, since it suffered a renewal of the debate. Finally, Belarus represents the implementation of the scenario of limited reforms (Type V: Limited or Reversed Reforms). It actually showed some modest early progress similar to many gradual reformers, but later this was halted and indeed reversed.

The synthetic Transition Progress Indicator (TPI) of the European Bank of Reconstruction and Development is used to rank and order countries. Transition indicator is based on a simple average of eight indicators each scored in the range 1 (no market reforms) through to 4 (conditions as in a developed market economy) or 4* (exceptionally strong development of market-based institutions). Scores with an asterisk are treated as adding one-third of a point to the aggregate. In 1995, it was 3.5 for the Czech Republic, 3.2 for Estonia, 2.8 for Croatia, 2.1 for Belarus, 2.1 for Kazakhstan, and 2.6 for Russia.[131] By 1999, it was 3.4 in the Czech Republic (fell by 0.1), 3.5 in Estonia (grew by 0.3), 3.0 in Croatia (grew by 0.2), 1.5 in Belarus (fell by 0.6), 2.7 in Kazakhstan (grew by 0.6), 2.5 in Russia (fell by 0.1). Actually, there are three milestones of TPI analysis. A TPI value of 2.5 represents the average reached the CEE and Baltic countries the year before their GDP started to recover, reflecting the notion that at least this much progress was needed to turn around the transition recession. Then, it is believed that if TPI equals to 2.7 it can indicate a half-market economy; and if TPI is 3.3, it indicates the near-market economy (reflecting a situation where market forces start to become more important than governmental plans or directives).[132] The Czech Republic has reached the first level in 1993, and the second one already in 1994. Estonia's TPI, reached 2.5 in 1993, 2.7 in 1994, and 3.3 1996. TPI in Croatia, in contrast, was 2.5 in 1994, 2.7 in 1995, and 3.3 only in 2000. However, the developments in CIS were significantly different. So, TPI in Russia has changed from 2.5 to 2.7 in 1995, and in 2003 it grew only to 2.9. In Kazakhstan, TPI equal to 2.7 was

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[131] Hare, P. G. (2001) pp. 14
[132] Havrylyshyn, O. (2006) pp. 162

reached in 1995 and again only moderately grew to 3.0 in 2003. Finally, in Belarus, TPI equal to 2.1 was realized in 1995, but unfortunately decreased to 1.9 in 2003.

In adopting a broad reform strategy and specific policies, a country in transition had to take into account its particular economic circumstances and political constraints. Typically, such strategy would consist of six major components: *micro-liberalization* (especially with regard to prices, trade and market entry); *macro-stabilization* (especially with regard to inflation, public finances and foreign debt); *structural changes* (especially privatization); *new market institutions* (with regard to commercial codes, property rights and the financial/capital markets sector); *safety nets*, and *external assistance*. The first four were crucial components of any reform package. Soaring unemployment and the elimination of most subsidies to households required a fundamental change in the welfare system, the external assistance was typically small and of limited impact. Liberalization, macroeconomic stabilization, structural changes and market institutions development need a more detailed analysis.

Gomulka (2000) comes to the conclusion that in all the types of strategies, there were differences and similarities: "... The similarities were possibly greatest with respect to micro-liberalization and certain important structural changes, notably re-orientation of foreign trade and privatization... Somewhat unexpectedly, the greatest differences initially emerged in the area of macroeconomic policy... These differences, however, narrowed down in the second half of the 1990s".[133]

3. 2. 1. Liberalization

Liberalization is usually divided into internal and external liberalization. Internal liberalization comprises the freeing of domestic prices and the abolition of state trading monopolies. External liberalization refers to the unification of the exchange rate and currency convertibility, the elimination of import controls and export taxes, and the substitution of moderate import tariffs for import quotas and high import duties, as, for example, mentioned in De Melo et al. (1996).[134] Authors and also *ERBD Transition Reports* have constructed a Liberalization index. It combines a number of different measures of liberalization with the same weight, although some factors are undoubtedly more important than others.

As it was mentioned before, the liberalization of prices, trade and entry was probably the held very rapidly and without a delay in the majority of countries in the region. The following assumptions about rapid price liberalization were taken into account:[135]

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133 Gomulka, S. (2000) pp. 2
134 De Melo, M., Denize, C., and A. Gelb (1996) pp. 24
135 Jeffries, I. (2002a) pp. 112

(i) The need to make use of the political 'honeymoon' period to make painful economic decisions;

(ii) Market-determined prices lead to a more efficient allocation of resources;

(iii) Queues and forced substitution of goods are eliminated when price controls are ended. Confidence is restored in the currency. The benefits of the elimination of queues include more leisure time and greater incentives to work (since money income can command control over goods and services). There is the argument that the welfare costs of monopoly are less than those of queues. Controls over prices and the consequent shortages encourage corruption and rent-seeking (the seeking of favors, such as subsidies, from the government);

(iv) Repressed inflationary pressures are eased as any monetary overhang (forced savings) is eroded. Although the release of most price controls leads to an immediate increase in open inflation, macroeconomic stabilization policies will gradually bring down the rate of increase in the general price level;

(v) The liberalization of foreign trade, including rapid current account convertibility, is emphasized: "... International competition would provide the competition in the internal market that ... firms themselves would not provide at the start... If free trade could be introduced, prices could be liberalized".[136] Likewise, Balcerowicz (1994) recommends that "... Comprehensive price liberalization should be complemented by comprehensive liberalization of foreign trade".[137] It is thus not only inadvisable but not even necessary to wait until privatization and competitive domestic conditions are created. (The existence of a healthy private sector at the start of the transition would, of course, enhance the supply response);

(vi) Woo (1994) argues that the common consequence of partial price reform is that "... The state is obliged to accede to requests for subsidies from loss-making firms that have their output prices controlled... There is little incentive for such firms to increase their efficiency because it is hard for the government to determine whether the losses are due to price controls or to mismanagement and misappropriation".[138] Similarly, Balcerowicz believes that slow price liberalization would prolong the existence of distorted prices. Thus the performance of enterprises cannot be judged reliably and the soft budget constraint is likely to persist as loss-makers are able to blame distorted prices.

Initially, liberalization was often seen as a sub-factor of financial stabilization, and perceived to bring about initial costs, as highlighted in Selowsky and Martin (1996) and

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[136] Sachs, J. (1994) pp. 50
[137] Balcerowicz, L. (1994) pp. 28
[138] Woo, W. (1994) pp. 278-279

Hernandez-Cata (1997). Over time, however, liberalization has emerged as the most important growth-stimulating factor in the transition countries. Berg et al. (1999) found that liberalization helps all countries in the later transition and most of them even in the early stage of transition. External liberalization has had a particularly great effect on output. For instance, Havrylyshyn and Wolf (1999) point out that most measures of structural reforms were closely correlated with reform in general. The only uniquely effective measure on its own was price liberalization.

Aslund (2002) believes that "...It is easy to understand why liberalization has had such a great positive impact on output... The slump was largely attributable to substantial shifts in relative price and demand, which rendered much of the previous production unsalable... This necessitated a change in the composition of output, which was facilitated by real competition and enterprise change... The recovery in real output is driven by dramatic changes in the sectoral composition of GDP".[139] Havrylyshyn and Wolf (1999) put it differently: "... [For] over-industrialized, distorted, and inefficient economies, recovery only comes after some elimination of the wasteful old production".[140] Sachs (1996) sums up the evidence: "...Experience suggests that a quick move on liberalization following the fall of communism was important in achieving comprehensive liberalization, since delays in liberalization gave time for vested interests to form around remaining barriers to trade".[141]

The late exit out of the ruble zone in the countries of the FSU deserves a special attention. According to Dabrowski (1995), the former Soviet currency, the ruble, remained in the first stage of transition in all post-Soviet states. That was true for both the nations that became members of the CIS in December 1991 and those which chose the path of full political separation (namely, the Czech Republic, Baltic States and former Yugoslavia). "...[But] strong disintegration factors began to influence the functioning of the monetary system, leading to the partial collapse of the monetary union in mid 1992 and the final collapse in the second half of 1993 ...All political attempts inside the CIS to rebuild, at least partly, the ruble zone, including the treaty on monetary union between Russia and Belarus failed because of the absence of the above mentioned political and institutional preconditions for the existence of a common currency".[142]

The Optimal Currency Area Theory first proposed by Mundell (1961) and later developed by McKinnon (1963) can be used to explain the delay in some post-Socialist countries in adopting own currencies. Both authors made *de facto* equation between the territory with a single currency and territory with many currencies but convertible one to other at the fixed exchange rate. McKinnon (1963) wrote that "...A fixed exchange rate system with guaranteed

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[139] Aslund, A. (2002) pp. 145
[140] Havrylyshyn, O. and T. Wolf (1999) pp. 31
[141] Sachs, J. (1996) pp. 129
[142] Dabrowski, M. (1995) pp. 6

convertibility of currencies is almost the same thing as a single currency regime".[143] However, as highlighted by Dabrowski (1995) both authors missed the problem of transaction costs which still exist under fixed exchange rates (even permanently fixed) and do not exist under single currency regime.[144] Under this perspective, it is easy to understand why Estonia exited the ruble zone as quickly as they could in contrast to Kazakhstan and Belarus that insisted that they would continue to use the ruble even though at the price of having the monetary policy dictated by the Central Bank of Russia. At the speech in August 1993, for example, Kazakhstan's President Nazarbaev explained that his state was technically prepared to leave the ruble zone, but that he believed it would be more profitable to stay in it.[145] On the other hand, the material incentives to remain in the ruble zone were irrelevant in the case of Estonia, according to Abdelal (2001). Notwithstanding the numerous warnings of global community (including those of IMF and European Community) of the consequences of exiting the currency union, Estonians seemed to equalize the new currency and the independence. For example, on June 22, 1992 they held the Kroon Ball to honor the symbol of their monetary sovereignty in the Viljandi "Ugala" Theater in Tallinn.[146] This difference in approaches towards the adoption of the national currency proves that external liberalization was much slower in CIS countries and consequently macroeconomic stabilization and structural changes have been delayed, in comparison to the countries of Central Europe and especially Baltic countries.

The liberalization index is comprised of a weighted average of three components, domestic market liberalization [weight 0.3], foreign trade liberalization [weight 0.3], enterprise privatization and banking reform [weight 0.4]; and scores in the range {0; 1}. This index measures reforms needed to make the markets the main mechanism for allocating resources, such as eliminating central planning and mandated allocations through government orders and creating conditions to allow private production. The index also covers reforms to ensure the efficient functioning of markets, such as stabilizing the macroeconomic environment, liberalizing the trade regime, and pursuing pro-competition policies. In 1998 the index was the highest for countries in Central Europe and the Baltics and the lowest for countries such as Belarus which had yet to embark on a course of reform, as stated by the World Bank (2002).[147] In the Czech Republic, it grew by more than 90 percent, changing from 0.00 in 1989 to 0.93 in 1997. Estonia's index grew from 0.07 in 1989 to 0.93 in 1997. Liberalization in Croatia was 0.41 in 1989 and 0.85 in 1997. In CIS countries the liberalization was completed only partially. For example, Belarusian index grew from 0.04 in 1989 only to 0.51 in 1997. Russia and Kazakhstan

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[143] McKinnon, R. (1963) pp. 717
[144] Dabrowski, M. (1995) pp. 7
[145] Abdelal, R. (2001) pp. 56
[146] Abdelal, R. (2001) pp. 46
[147] WB: *"Transition. The First Ten Years..."* (2002) pp. 14

were more rapid liberalizing from 0.04 (1989) to 0.83 (1997) and from 0.04 (1989) to 0.86 (1997), respectively.[148]

3. 2. 2. Macroeconomic stabilization

As of the macroeconomic environment, it had to meet several criteria to be conducive to investment and growth, as summarized by Gomulka (2000). Some of them are very similar to the objectives of the Washington Consensus. These criteria would be then used for the evaluation of the progress which the countries have made during 1990s:

(i) The inflation rate to be in the moderate range of 10-40%, with a good prospect of it falling below 10% and remaining in the 0-10% range;

(ii) The general government (GG) budget deficit to be reduced from the initial 5-30% of GDP for most countries to a level below 3% of GDP, with a high premium given to a policy of a budget surplus;

(iii) The public debt to be reduced from its pre-transition level of some 50% to 60% of GDP to a level significantly below 60% of GDP;

(iv) The GG expenditure to be reduced from its pre-transition level of some 50% or 60% of GDP to a level in the range of 30% to 40% of GDP;

(v) Official reserves of international exchange to equal at least 4 months of imports of goods and services, exceed total (public and private) short-term foreign debt, and be equal to at least 1/3 of public foreign debt;

(vi) Direct taxes (especially profit taxes) to be low, together with social insurance contributions providing revenues of less than, say, 20% of GDP;

(vii) The monetization of the economy to be substantial, equal at least to 30% of GDP;

(viii) The lending rate to be below 20% in nominal terms and below 10% in real terms.

The first three criteria are of the Maastricht criteria. They are interdependent. Those countries which intend to join the EU will need to meet Maastricht criteria on inflation and the budget deficit, thus would have to keep public debt at a level (significantly) lower than 60% of their GDP.[149] Bruno and Easterly (1998) claim that regressions have shown that an inflation of 40% a year is the critical threshold for economic growth. However, at the beginning of transition only the Czech Republic and Hungary were not hit by the inflation of over 100 percent a year. Financial stabilization became the natural focus of economists' attention, especially as macroeconomists and the IMF came to the fore. Many have criticized this preoccupation with macroeconomic stabilization, with high inflation being detrimental to growth. According to

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[148] See Table 3.3 pp. 108
[149] Gomulka, S. (2000) pp. 10-11

Aslund (2002), virtually all the multi-country regressions have found a strong correlation between high inflation and falling output.[150] The common motivation behind criteria (ii), (iv), and (vi) is to increase national savings and improve incentives for work and investment. (v) is intended to reduce the exchange rate risk and (vii) serves to indicate that the banking sector has developed sufficiently to intermediate effectively between savers (mainly households) and investors (mainly enterprises).

At the beginning of transition the countries had very large governments and public enterprise sectors, making it difficult to distinguish between monetary and fiscal policy. In the centrally planned economy there was no private sector at all, so there was no separate public sector and no public sector deficit or debt. Without a private sector, monetary policy is simply the provision of finance for investment in the plan. Consequently, fiscal and monetary policies were the same thing. As economic transition developed, privatization created a private sector and the distinction between public and private sectors has acquired a macroeconomic significance. Figure 3.1 illustrates the dynamics of governmental expenditure throughout the region in the comparative perspective.[151] In this perspective the fiscal policy gradually emerges as the concepts of public expenditure, tax revenues, government budget and public debt becomes operational. Branson, de Macedo and von Hagen (1998) explain the natural creation of the monetary policy during economic transition: "… With the creation of a central bank, and the withdrawal of the central bank from automatic financing of the budget deficit, monetary policy emerges as the provision of credit to the private sector… During the transition, the countries are expected to introduce market-oriented policy-making institutions in which the distinction between fiscal and monetary policy is clear".[152]

Combining data from various sources, Havrylyshyn (2006) has calculated the start of macroeconomic stabilization in selected countries.[153] Under his perspective, the Czech Republic has launched the stabilization in January 1991, only a month after the official start of economic transition. In contrast, it took 18 month to begin macroeconomic stabilization in Croatia.[154] It took 10 months to realize first stabilization efforts in Estonia, in June 1992. In contrast, even though the official beginning of transition was launched in 1992 in all CIS countries, in the case of Belarus it took 40 months to start stabilization measures in November 1994 (and it is still a matter for the debate). Russia's first stabilization undoubtedly started with Gaidar's reforms in January 1992 but unfortunately they failed. Finally, in Kazakhstan it took 38 months to begin

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[150] Aslund, A. (2002) pp. 141
[151] See Figure 3.1 pp. 103
[152] Branson, W. H., J. B. de Macedo and J. von Hagen (1998) pp. 4
[153] Havrylyshyn, O. (2006) pp. 160
[154] Even though the stabilization officially began in August 1991, it was stillborn due to war financing, while a second attempt was tried in December 1992, it was factually delayed until the October 1993

real stabilization (in January 1994), and the Government has achieved noticeable progress in its efforts toward macroeconomic stabilization, especially in the reduction of inflation.

The delay in achieving stabilization can be measured as a sum of the delay in undertaking an effort and the time to reach 5% inflation per month on a sustained basis for at least one year.[155] The Czech Republic and Estonia achieved this within a year, but Croatia had two unsuccessful attempts in 1991 and 1992 as war activities continued, but on the October 1993 the program achieved an almost immediate drop in inflation well below 5% per month. Russia, Kazakhstan, and Belarus generally suffered extremely high inflation lasted for 3-4 years. In Russia, after 1998 default and sharp devaluation there was a relatively mild resurgence of inflation which spilled over some neighboring countries (including Belarus and Kazakhstan), but since then inflation has fallen to single digits annually. In contrast, Belarus continues to have inflation as high as 20%. The main reason is in initial stabilization. Its first effort were about as effective as in Kazakhstan and Russia, but have not continued towards the ultimate goal of single-digit annual inflation seen in virtually all other transition countries.

Thus, macroeconomic stabilization was not a smooth process in all countries. Comparing CBS countries and the FSU countries, it is clear that there were differences. For instance, in Russia, Belarus, and Kazakhstan both inflation and budget deficits have been much higher than in CEE and Baltic States, but public expenditures have declined more sharply. Also, gross reserves have increased to adequate levels in CEE, but still remain low in CIS countries. Plus, the ratios of broad money to nominal GDP have been remarkably stable, at moderately high levels in CEE and Baltic countries, but declined sharply during the high inflation period in the CIS region, where they stood at very low levels at the end of 1990s.

In 1992 and 1993, the Russian Government expanded the money supply and credits at explosive rates that led directly to high inflation and to deterioration in the exchange rate of the ruble. In the second and third quarters of 1992, the money supply had increased at especially sharp rates of 34 and 30%, respectively, and by the end of 1992, it increased by eighteen times. Government efforts to control credit expansion were semi-successful. By mid-1992, when the amount of unpaid loans had reached 3.2 trillion rubles (about US$20 billion), the government froze enterprise debts. Shortly thereafter, the government provided 181 billion rubles (about US$1.1 billion) in credits to enterprises that were still holding debt. The Government also failed to constrain its own expenditures in this period. By the end of 1992, the Russian budget deficit was 20% of GDP, much higher than the 5% projected under the economic program and stipulated under the IMF conditions for international funding. This budget deficit was financed largely by expanding the money supply. These ill-advised monetary and fiscal policies resulted

[155] Havrylyshyn, O. (2006) pp. 163

in an inflation rate of over 2,000 percent in 1992. In late 1992, deteriorating economic conditions and a sharp conflict with the parliament led Yeltsin to dismiss economic reform advocate Gaydar as prime minister. His successor was Viktor Chernomyrdin, who was considered less favorable to economic reform. By mid-1996 many Duma deputies raised concerns about the government's failure to meet its tax revenue targets. Revenue shortages were blamed on a number of factors, including a heavy tax burden that encourages non-compliance and an inefficient and corrupt tax collection system. A variety of tax collection reforms were proposed in the parliament and the government, but by 1996 Russian enterprises and regional authorities had established a strong pattern of non-compliance with national tax regulations, and the Federal Tax Police Service was ineffective in determining the violators.

In Belarus, the monetary and fiscal policies have been uneven and inconsistent over the years of transformation. According to Korosteleva et al. (2003), "... This led to chaotic measures in the early 1990s, a tough stance in 1994-1995, a reverse move to command-administrative measures in 1996-1998, and a reintroduction of stricter monetary discipline since 1998... [Also] command-administrative measures have been used to resolve macroeconomic problems... [Plus] due to the specificity of central planning structures, the move to a market-type system, while preserving plenty of characteristics typical of the previous one, has created a situation where market institutions, such as money, exchange rates and credits fail to perform their functions".[156] Taking into account the difference between public revenues and expenses in Belarus accounting for nearly $450 billion in 2005, it seems the government is not very successful in coping with the public debt.

Kazakhstan, in contrast, has never applied a tight monetary-credit policy. Early in 1992, the government promulgated a decree that envisioned broad credit and tax privileges (to stimulate industrial production) and an increase in the emission of credits. Despite proclamations, the government had to cover its expenditures with an enormous budget deficit. Actually, during the entire course of reform, its fiscal and budgetary system showed growing imbalances; financial instruments ceased to exert a regulatory effect. In some years, the volume of the budget deficit amounted to nearly one-third of the GDP.[157] In 2004 public debt accounted for 13.7% of GDP.

Actually, most transition countries succeeded in bringing down inflation rates, reaching reasonable price stability by the mid-1990s, but several countries experienced a resurgence of inflation in the second half of the decade. Particularly, Belarus and Russia are the countries with the U-shaped stabilization pattern. While external shocks (for example, the role of the regional

[156] Korosteleva et al. (2003) pp. 142
[157] Rumer, B. Z. (1996) pp. 213

war in the Balkan area for Croatia's policies) played a role in some cases, an important common factor seems to have been the failure to pursue the reform agenda consistently and vigorously. "... The resulting buildup of bad loans in the banking sector and the government debt eventually led to a loss of confidence among both domestic and external creditors, entailing currency and banking crisis in the countries concerned... Among the stabilization setbacks experienced by various countries, the Russia crisis of 1998 was the most serious, caused by a fiscal policy stance that turned unsustainable – especially when combined with an exchange rate policy aimed at nominal exchange rate stability – and exacerbated by the lack of prudence among international lenders".[158]

Czech's fiscal policy during the economic transformation can be divided into two basic phases. The first period (1993 – 1998) could be characterized as "conservative" fiscal policy aiming to achieve a balanced state budget and a reduced role for the state in the economy. In the second phase (1998 – up to the present) fiscal policy has been redirected towards strengthening of the state's role in the economy. According to Matalik and Slavik (2002), "... One of the consequences is a growing public finance deficit... The widening deficits of the general government budget now place at risk the achievement of economic and monetary policy objectives".[159] Precisely, during 1993-1998, the government's fiscal policy was directed towards establishing a legislative and technical framework comparable to that in modern market economies. In the public finance area, it involved, for instance, introduction of a completely new tax system from 1993 and an explicit fiscal target of no increase in the nominal state debt (implying a decrease as a ratio to GDP). There was an intensive political and economic debate about establishing a legislative requirement for balanced state budgets, but the proposals were not accepted by the parliament. Since 1998, the policy has been based on other, often opposite, priorities. In 2002 the government openly opted for promoting economic growth by means of public budget deficits. Some special off-budgetary institutions were established to carry out public investments in certain areas. This decreased the control of the ministry of finance over the overall development of the public finances and led to a further fragmentation of government budget structure.

As of the budget constraints in Estonia, the country has faced were several challenges too. Among these was a high enterprise tax debt to the state. Another danger to the monetary stability was posed by the collapse of several private banks because of insolvency. The president of the Central bank, Siim Kallas, made "hard money" the benchmark of his policy. In 1993 the central state budget ran a surplus of EKR216 million on total revenues of roughly EKR 4.2

[158] IMF: "*World Economic Outlook*" (2000) pp. 97
[159] Matalik, I. and M. Slavik (2002) pp. 122

billion (US$323 million). About half of the revenue for the central budget came from 18 percent value-added tax (VAT) on most goods and services. In all, general government taxes (including local taxes) in 1991 amounted to about 47.7 percent of GDP.

Sekiguchi (2006) has summarized the fiscal improvements in Croatia. Actually, the country's budget is in chronic deficit. However, with support from the IMF, the government has made restoration of fiscal health of its basic policy for medium-term fiscal management. Although there have been phases when the growth rate slowed down and the deficit widened (compared to the initial projection), so far the government appears to have been comparatively successful in reducing public debt. The fiscal deficit, which was 6.3% of GDP in 2003, was reduced to 4.9% in 2004 and 4.2% in 2005. In its 2006 budget the government has set a target of 3.3% of GDP.[160] In its 'Economic and Fiscal Policy Guidelines' for the next three plan years, the government has drafted a policy of cutting the general government deficit to 2.8% and reducing public debt to 46.7% of GDP (2005 estimate 49.9%) by 2008.

3. 2. 3. Structural changes

As of the structural changes, they were supposed to begin at the same time as the stabilization programs.[161] The main building block was privatization with the main aim to create a private sector, but also to create state enterprises work as market-oriented firms, a process called marketization or commercialization. Table 3.4 illustrates the performance of countries in terms of structural transformation.[162]

The private market economy was assumed to appear with the help of several measures. The first consisted of privatization and the dismantling of the former state monopolies; introduction of free competition rules, establishment of free entry on the market for business creation, and free flexible labor market. The second measure assumed the reform of the banking and financial sectors and tax reform. According to Branson, de Macedo and von Hagen (1998), the absence of a tax system (which is efficient, equitable and simple to run) is seen as a major microeconomic and macroeconomic obstacle to growth, as well as to social consensus. The same is true of the absence of a transparent legal environment, which deters domestic and foreign investment.[163] Third measure meant to develop of a social safety net, thus replace the former all-embracing protection system, and also to cushion the impact of the austerity measures and of the structural transformation. Finally, the initiation of an industrial policy could identify the 'winners' and 'losers' in the industrial activities (to be restructured); define of the activities in

[160] Sekiguchi, K. (2006) pp. 3
[161] Lavigne, M. (1999) pp. 162
[162] See Table 3.4 pp. 109
[163] Branson, W. H., J. B. de Macedo and J. von Hagen (1998) pp. 3-4

need of support and devise appropriate policies (such as subsidies, protective tariffs, etc.) at least to stop the damages caused during the former regime.

Privatization has been heralded both as the key solution, as for example, in Yavlinsky and Braguinsky (1994) and as of little consequence (Stiglitz (1999)), and it has been undoubtedly the most controversial part of the transition. Among studies with regressions of the impact of privatization on economic growth, the relation seems unanimous. However, there is a strong positive correlation between the share of GDP arising from the private sector and output, as in Aslund et al. (1996) and Havrylyshyn and Wolf (1999). There is a strong perception that privatization has been less effective in CIS countries than in the CBS states. However, the main aims of privatization have experiences a degree of consensus. It actually had to lead to real, clearly defined, private property rights. The new owners must be endowed with effective control over management. Besides, it had to be socially acceptable and should facilitate the enhancement of economic efficiency both within the privatized enterprises and in the economy as a whole. Reforms of the banking and tax systems, and creation of capital markets, were also among the first priorities of the policy-makers and advisors. Though most of the advisers also advocated the creation of a social safety net, which was meant to replace the former state of 'paternalism', this is usually seen as a luxury in the East.

The easiest privatization (namely, small-scale) in every country involved small shops and kiosks, according to Aslund (2002).[164] It was held in the reformist countries even before the collapse of the USSR. In this type of privatization, problems have been mainly caused by local regulations, such as short leases on premises, licenses that must be renewed every year, limited rights to change the profile of a shop, restrictions on the laying off of workers, and dependence on state wholesale trade. What was really different is the choice of the strategy for the privatization of the medium and large-scale enterprises. Table 3.5 illustrates the variations between countries.[165]

Hence, a direct sale to outsiders (or investments tenders) was one of the methods of selling large-scale enterprises. The advantages of this method were substantial: one or a few outsider owners would acquire substantial ownership and be motivated to pursue progressive enterprise restructuring, and they could be designed to attract foreign investors. They can also raise considerable revenue for government. However, direct sales tend neither to be transparent nor to dis-encouraging corruption – they are often little more than give-away to the rich and well-connected. Estonia has privatized a substantial portion of its industry including the phone company, the national airline, and railway. By January 1995, 80 percent of the total number of

[164] Aslund, A. (2002) pp. 268
[165] See Table 3.5 pp. 110

enterprises was privately held. However, these firms represent only 50 percent of the employment and 40 percent of the industrial output. Thus, privatization is moving forward on the firm level but may slow down with regard to large, unprofitable, state-owned enterprises. Privatization of land has been slower, and there are significant regional differences.[166]

Virtually all countries have undertaken some direct sales and investment tenders. Their success however was different in different countries. States with the best public administration (including the Czech Republic) used this method merely, and only in these countries privatization became a substantial source of state revenues and such sales were publicly accepted. These countries became the major recipients of FDI per capita. However, looking East and South, "... the results of direct sales and investment tenders have been nothing but disastrous".[167] The revenues have been insignificant, because these "sales" were like to giveaways to the rich and powerful. The more direct sales and investment tenders that took place, the more corrupt the privatization process was. Particularly, in Russia and Kazakhstan these direct sales coincided with the evolution of large "financial-industrial groups".[168]

The Croatian government's early decision to start the privatization process cannot be understood only in terms of the standard economic explanations about the advantages and benefits of a market economy. There were some strategic political reasons as well. The first privatization legislation was passed in April 1991, while the country was still within the Federal state and some share of the Serbian population was in open rebellion. Changing property rights by privatization and restructuring the basis of the economy was expected to achieve several political objectives. First, it would demonstrate to the European Community and others in the "West" the new government's commitment to capitalism and a Western type of economy (the authorities maintained that the political system was already democratic and constitutional, based on the new Croatian Constitution of December 1990). Secondly, privatization would distinguish the Croatian economy from the other Federal republics, and strengthen the grounds for state independence, once that issue came to the fore. It would also make it simpler to disentangle the Croatian economy from the Federal economic structures. Thirdly, privatization would be the ultimate instrument for purging the economic sphere of communist influence (during the event, communist managers were the only people around with the expertise to run the economy, and they showed remarkable skill in buying out the firms they managed). Furthermore, the redistribution of economic wealth and power would help the new political élite to gain control over the real sources of power. Finally, taking over the main sectors of the economy and

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[166] Hoag, J., and Kasoff, M. (1999) pp. 4

[167] Aslund, A. (2002) pp. 272

[168] These groups did not promote the de-politicization of enterprise, de-monopolization or enterprise restructuring, because their main asset was political influence, and they were so powerful that they tended to capture the state

declaring them state (as opposed to "social") property helped to stabilize the system and preserve asset values in turbulent times, while providing budget revenue for the state and the police and for building up the Croatian armed forces.[169]

The large majority of privatizations have been management or worker buy-outs. Some 200 publicly owned enterprises which had not lodged their proposals for privatization passed completely into the hands of the Privatization Fund. Shares not sold when enterprises were converted were taken up by the Privatization Fund (two-thirds) and the Pension Fund (one-third). 10 percent of capital was set aside as a provision for restitution claims. Enterprise employees and pensioners receive a discount of up to 50 per cent and have access to an interest-free loan for five years. The deadline for the privatization of all socially owned enterprises was originally set for the end of June 1992; all shares not sold by that date (around 50 per cent of the value of all state-owned enterprises) were transferred to three state funds without compensation. In October 1996 parliament passed the law on compensation for property taken during Yugoslav communist rule, regulating the denationalization of property confiscated or nationalized since 1945. It gives preference to restitution of property where possible (agricultural land, forests, some housing) and provides for compensation in other cases (other housing, developed construction and land).[170]

Voucher privatization was a pet idea of liberal economists and possibly the only real invention of post-communism. It became a dominant form of privatization in both the Czech Republic and Kazakhstan. It is believed that in the Czech Republic political goals have turned the privatization process into this aim *per se*. The government wanted to take state property away from its former Communist management, which had largely survived the change in the political regime. Hence the speed of privatization was crucial, and it was impossible to resort to sell-offs. Thus the country was the first country to launch a 'voucher-type' program which allowed citizens to obtain shares of state companies at symbolic nominal price. For the same reason the country was the only to provide a physical restitution of industrial assets in addition to land and housing (nationalized after February 1948). The process of privatization was launched in the beginning of 1992, involving about 2000 enterprises of which almost 1500 were auctioned.[171] After the partition of Czechoslovakia, Czechs decided in 1993 to go ahead for nearly 1000 companies, the second wave began in April 1994. The process was declared as completed in 1995.[172] Mass privatization through vouchers could be virtually distributed among the whole population. The distribution of vouchers alleviated the shortage of domestic demand for property purchases. Initially, the suddenly emerging voucher funds in the Czech Republic facilitated the

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[169] Simai, M. (1999) pp. 117-119
[170] Jeffries, I. (2002b) pp. 229
[171] PlanEcon (1993) pp. 1
[172] Lavigne, M. (1999) pp. 173

investment for ordinary people. As it was highlighted in Ježek (1997), the investment funds were a late improvisation in the Czech voucher privatization and time did not suffice for their regulation, but after they have emerged as major owners, they resisted being regulated. The Czech voucher funds became closely linked to the still state-owned banks, seemingly nullifying much of the privatization.[173]

In Kazakhstan, similarly, privatization of a state property became a key focus of the economic policy (over 90 percent of all property). It was believed that transition to a market economy would be exceedingly difficult unless the reform created a critical mass of private and non-state property ownership based on market principles. Privatization commenced in 1992 by targeting small-scale business. During 1992-1995, more than 15,000 enterprises were privatized; over half of them were small businesses. In 1994-1995 the state carried out privatization through auctions, direct sale, but primarily through vouchers. In 1994 the "investment privatization funds" (IPF) were established, distributing privatization checks to the general population.[174] However, the distribution of vouchers among 170 government-licensed investment funds had been problematic. In 1994-1995 twenty funds accumulated for nearly 60 percent of all vouchers. One fund, namely Butia-Kapital, received nearly 10 percent of vouchers, the largest single holding. This fund was widely rumored to be controlled by a nephew of President Nazarbayev. Other complaints focused on the too low price for the enterprises set by the government and the favored funds receiving "sweetheart" deals.

In Russia, a variety of forms of privatization was anticipated, and there was a heavy emphasis on an early break-up of monopolies. Enterprises showing initiative were given a priority. Potential revenues from sales of state enterprises were considered a significant contribution toward balancing the budget and financing macroeconomic stabilization. The 500-day program established the need for fast, massive privatization. Several authors of the 500day program, notably Grigory Yavlinsky, insisted on sales rather than free distribution of property.[175] The Minister of Privatization Chubais was committed to voucher privatization, but only 20 percent of the stocks in the 16,462 enterprises that went through voucher auctions until June 1994 were sold for vouchers, while 51 percent of the shares were usually given to managers and workers for the cheaper price, according to Blasi et al. (1997).[176] Furthermore, the most attractive enterprises were usually withheld from voucher auctions. As a consequence, people were disappointed, obtaining less than their anticipated share of national property, especially as

[173] Ježek, T. (1997) pp. 477-488
[174] Rumer, B. Z. (1996) pp. 202-203
[175] Aslund, A. (1995) pp. 226
[176] Blasi et al. (1997) pp. 192

their expectations were exaggerated by the reformers' propaganda about the potential benefits of privatization. Thus, the insider-type voucher privatization became dominant in the country.

The structural changes in Belarus are interesting to analyze. Due to communists' domination in the government, the long-awaited law "*On Destatisation and Privatization of State Property in the Republic of Belarus*" was adopted only in January 1993. By the time when the process started to work, the political commitment changed (1994), and Lukashenko halted privatization on the grounds of corruption. In subsequent years there was little ownership reform. In 1996 and 1998 the state privatization program underwent further changes, but they did not bring serious ownership restructuring. Usually, privatization took the form of voucher scheme. It was established in 1994 and has suffered from a number of deficiencies, as summarized by Korosteleva, Lawson and Marsh (2003):[177] "... First, the idea of exchanging vouchers for enterprise shares meant that enterprises did not receive any financial inflow on change of ownership... Second, there was a certain incompatibility between the speed of corporatization and the issue of new vouchers... Through the deadline for the application of vouchers was extended due to low public interest (from 1996 to 1997), the rate of corporatization was even slower, which did not give the potential investors any adequate choice of enterprises... Created as alternative institutions for the public investment of vouchers, investment funds were suspended by the President in the mid-1990s... Finally, the high inflation has been depreciating the value of vouchers... As a result of these and other problems, the process of voucher privatization was very slow... Only half of the issued vouchers had been used by 2000". But in practice privatization of large firms delayed by the government under various pretexts had not even started. Also, much resistance to privatization also came from factory managers and politicians, particularly at the local level.

As of the creation of the banking sector and capital markets, countries again followed different patterns. For example, ERBD has classified the bank reform in the Czech Republic as "3" [Fully-established two-tier system; framework for prudential regulation; significant presence of private or foreign banks though the banking sector remains state-owned in its majority; beginning of a lending policy though banks remain risk-adverse and lack experience in assessing the solvency of the enterprises, thus restraining credit and contributing to generate inter-enterprise arrears] and the country's development of capital markets as "3" [Creation of investment vehicles (investment funds, insurance, pension funds); opening of stock exchanges; issuance of securities by private enterprises and by the government]. Actually, since 1993 Czech National Bank as well as 25 commercial banks was fully operating. Also, Prague Stock Exchange was established in 1993. Estonia has reached "3+" for bank reform and "3" for capital

[177] Korosteleva, Elena A., C. W. Lawson, R. J. Marsh (2003) pp. 146

markets. Its Central bank was independent of the government but subordinate to the parliament. Between 1992 and 1997 the number of operating commercial banks dropped from 42 to 14. Unprofitable banks closed or merged with profitable ones.[178] After this painful experience the sector became more effective and transparent. On the other hand, CIS countries were less successful. As of the reform of the banking sector, Russia got "2+" [Liberalization of interest rates and credit allocation; limited use of directed credit of interest rate ceilings] and "3" for capital markets. Kazakhstan was as slow as Russia in terms of bank sector and even weaker in terms of capital markets, "2" [Legislation for the setting up of stock exchanges; some trading in government bonds]. Belarus performed even worse. By 1997 it reached only "1" for the banking reform (two-tier system; no further reform). Capital markets were as weak as in Kazakhstan with the result of "2". [179]

3. 2. 4. The role of weak institutions

In its 1998 volume *'Institutions Matter'*, the World Bank defines institutions as "... formal and informal rules and their enforcement mechanisms that shape the behavior of individuals and organizations in society".[180] A similar definition is used in the new institutional growth literature, which claims that institutions dominate policies. For instance, Acemoglu, Johnson, Robinson and Thaicharoen (2002) define institutions as a cluster of social arrangements that include constitutional and social limits on politicians' and elite's power, the rule of law, provisions for mediating social cleavages, strong property rights enforcement, a minimum amount of equal opportunity and relatively broad-based access to education.[181]

Simultaneously, Gomulka (2000) believes that the ultimate success of transition depends on the establishment of appropriate market institutions supporting macroeconomic stability, entrepreneurship and competition. Such institutional changes are inherently slow and depend on the political commitment to reform of governments and parliaments, and on their practical effectiveness in implementing reforms and policies. This commitment is clearly stronger and its effectiveness probably greater in Central Europe and the Baltic countries than in the CIS.

As of the institutions' role, Hare (2001) concludes that "... Institutional change in the widest sense is absolutely vital for sustained growth and recovery of the transition economies... This does not, of course, deny the importance of sound government policies, both to maintain

[178] Hoag, J. and M. Kasoff (1999) pp. 2
[179] Lavigne, M. (1999) pp. 200-202
[180] The WB: "*Beyond the Washington Consensus...*" (1998) pp. 11
[181] Acemoglu, D. et al. (2002) pp. 7-8

macroeconomic stabilization and to promote through deliberate state action the very institutional reforms that must be in place for growth”.[182]

Due to the severe deficiency of institutions in the first decade of the transformation the additional dimension of difficulty to policy-making was added. Macroeconomic management was particularly difficult in the new countries of CIS, which initially lacked their own currencies and central banks and which almost did not have the financial reserves for the independent financial system creation. It is worth mentioning that it took the new countries of the FSU some 4-5 years to establish the basic institutional framework needed to conduct a reasonable macroeconomic policy – by creating central banks, new currencies, bank supervision, international payments systems, new taxes and tax collection systems, stock exchanges, securities commissions, labor exchanges, and new social benefit systems. The result was in a significant improvement in a macroeconomic environment of those countries in a second half of 1990s.

An early awareness of the importance of institutions is evident in Fisher and Gelb (1991). Fisher and Sahay (2004) have calculated the correlations among various measures of institutional reforms. Particularly, they took legal variables (representing institutional changes), their average correlation with the overall reform index was about 0.7. Another correlation was constructed between the reform index, institutions (such as commercial and financial law, and the state capture index[183]), and initial conditions; and showed a low correlation. Authors believe that this result suggests that while progress can be made in legislating laws, their implementation may lag behind. One important conclusion should be kept in mind: “… It is sometimes assumed that a country’s institutions are determined by a more or less immutable history, and thus must be slow to change… Institutions can change, particularly at the time of crisis… Our ability to predict which institutions are immutable is slow… So, at the same time as we emphasize the role of institutions in growth and development, we should also recognize that institutions can change… And they have changed during the transition process in the former Soviet block”.[184]

The index of the institutional quality is based on five components (extent of democracy, government effectiveness, extent of regulation, rule of law, and extent of corruption) and is scored in the range {-25, 25}. Comparing the index values in 1997-1998, it is possible to conclude that the Czech Republic is the first with the 6.8 result; then goes Estonia with 6.1 result; Croatia is the third (0.3); and CIS countries performing negatively, namely, -5.3 in Kazakhstan, -5.4 in Russia, and -7.6 in Belarus. However, despite the positive results in the CBS

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[182] Hare, P. G. (2001) pp. 20

[183] Measurement of efforts of firms to shape the rules of the game to their advantage through illicit, non-transparent provision of private gains to public officials

[184] Fisher, S. and Sahay, R. (2004) pp. 10

countries, the developed market economies the average scored 12.6, so even the European countries in transition stand on the middle position, if compared with the Western Europe and the US.[185]

3. 2. 5. Putting the pieces together

De Melo et al. (1997) have concluded that policy is still the most important factor determining growth differences throughout the region. Political reforms emerge as the most important single determinant of the speed and comprehensiveness of economic liberalization.[186] The role of the transitional reforms was constructively summarized in IMF (2000): "… The slower output in CIS countries, compared to the EU accession countries, has been mostly associated with less vigorous and more limited structural and institutional reforms, as well as less successful stabilization policies, entailing greater macroeconomic instability following the onset of transition… A wide body of research suggests that countries with deeper and wider reforms experienced an earlier resumption of output growth and a faster reduction in inflation, while delaying key structural reforms or stabilization measures did not prevent output decline… The countries that implemented more ambitious structural reform programs were also the ones that were more successful in achieving macroeconomic stabilization".[187]

In the session *"Lessons from the Transition Process"*, the analysts have reflected main developments in the reformation. Hence, they concluded that delaying certain key reforms (price and trade liberalization, and the elimination of the soft budget constraints, etc.) has typically been associated with higher and more protracted inflation and a less robust recovery from the initial output fall. They also believe that privatization strategy should start with a rapid privatization of small-scale enterprises and adopt a more gradual approach for large enterprises, depending on the introduction of commercial legislation to support adequate corporate governance structures and to provide effective competition (or regulations in case of natural monopolies).

They continue that the importance of institutional reform was recognized at the beginning of the transition, but in practice it was given too little attention in terms of macroeconomic developments by both policymakers and advisors, probably because the difficulties in implementing these reforms had been underestimated. "… Building an effective institutional and legal infrastructure in support of the market and private sector activity, while essential to the ultimate success of transition, is inevitably time-consuming and complex, and it also requires adjustments in the social practices and behaviors of both governments and private sector

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[185] See Table 3.3 pp. 108
[186] De Melo, M., C. Denizer, A. Gelb, and S. Tenev (1997) pp. 41
[187] IMF: "World Economic Outlook" (2000) pp. 114

agents... The experience of the EU accession countries strongly suggests that an external political anchor can greatly assist institution building and implementing governance reform".[188]

Finally, the role of the exchange rate regimes (that was debated at the initial phase of transition process) has not turned out to be a crucial determinant of success or failure of stabilization. Countries at both extremes of the exchange rate regime spectrum (currency board in Estonia compared to floating exchange rates in the CIS countries) were able to bring inflation down rapidly, as long as they kept the money supply and related fundamentals under control. Whenever monetary and fiscal policies were not supportive, however, using exchange rate policies to combat inflation was not successful, as exemplified by the Russian crisis of 1998.

As of the macroeconomic challenges, fiscal policy is believed to be one of the most crucial aspects. High levels of government expenditure and a lack of effective tax collection system generate pressures for large fiscal deficits. This problem is further complicated by the non-transparent and quasi-fiscal nature of much government spending, often associated with implicit subsidies for existing enterprises. On the other hand, countries that are less advanced in terms of structural and institutional reforms continue to maintain large subsidies for enterprises, extensive price controls, and restrictive capital controls. In these countries, central bank supports for the budget, banking system and enterprises continues to fuel rapid growth in the money supply and high inflation. The resulting macroeconomic instability is unlikely to disappear without fundamental structural reform.

On the other hand, all countries in transition (including those that have advanced most towards meeting the requirements of a well-functioning market economy as the Czech Republic, Croatia and Estonia) continue to face challenges in structural reform and institution-building in a broad range of areas. The need for structural reform is especially pressing in the CIS countries (including Russia and Kazakhstan, not even mentioning Belarus), where reforms have been partial or slow and are in some cases obstructed by special interest groups. The reform agenda varies among countries, and in most cases reforms will have to be carefully prioritized and sequenced in accordance with the available administrative and institutional capacity. Three areas appear particularly critical to the analysts of the International Monetary Fund (and in which countries face common challenges): restructuring of enterprises, building of a market-based financial sector, and transforming the role of the state.[189]

Table 3.6 summarizes the areas of remaining major reform backlog in comparative perspective.[190] It is obvious that the Czech Republic has no major gaps in reform implementation; the same picture is observable in Estonia, clearly indicating the effect of the EU

[188] IMF: "World Economic Outlook" (2000) pp. 120
[189] IMF: "World Economic Outlook" (2000) pp. 123
[190] See Table 3.6 pp. 111

accession played a dominant role during the first decade of transition towards a full market economy in these countries. Croatia holds a middle position, since the main problems remain in competition policy, securities market and non-bank financial institutions and budget deficit (projected budget deficit in 2000 exceeding 5% of GDP). CIS countries are visibly less advanced with the reform implementation. Russia, Kazakhstan and Belarus still have to combat the serious weaknesses in the areas of governance and enterprise restructuring; competition policy; banking reform and interest rate liberalization; and securities markets and non-bank financial institutions. Belarus is probably the worst case in the study, because it has in addition major backlogs in the areas of large-scale and even small-scale privatization, price liberalization, trade and foreign exchange system, commercial law, financial regulation law and inflation exceeding 5% of GDP (as of 2000).

The most obvious tendency can be drawn out of the reformation developments throughout the region. The countries of the Central Europe, Baltic region, and South-East Europe have visibly moved further in terms of the policy implementation, in contrast to the CIS countries, which still have to cope with numerous challenges. The proximity to the Western markets seems to be the dominant factor underlying the outcomes of the reformation. Policies are usually interdependent, so it is difficult to define the role of the single policy. However, the analysis of the main reform areas (macroeconomic stabilization, liberalization of prices, trade and entry, and structural reforms (including privatization) prove the idea that the high level of development in one area is in the majority of cases is supplemented by high developments in other areas. For example, it seems clear that tight fiscal and monetary policies (with the main aim to cope with extreme inflation rates and hold budget deficit at a low level) assume the particular development of the banking and financing sectors and creation of a viable tax systems. Also, the high level of structural changes can be the basis for the well functioning corporate governance system in the medium and large-scale enterprises. However, there are cases where the intensity of different reforms differed. For example, the rapid PTE (prices, trade and entry) liberalization in the case of CIS countries was not accompanied with the sufficient level of stabilization or structural reform at the beginning of 1990s.

Actually, the explanation of divergent developments throughout the region with only initial conditions, economic policies and institution-building seems not sufficient, since such factors as EU membership on the one side of the spectrum and vulnerability to rent-seeking (and state capture as a result) are not given the appropriate attention.

3. 3. An alternative approach – the Transition Navigation Model by Havrylyshyn (2006)

Due to the numerous inconsistencies in the comprehensive approach mentioned in the Section 3 (with the main weakness of one factor acting differently in different countries, for instance, location or strength of nationalism), it seems logical to introduce the alternative approach. Havrylyshyn (2006) has proposed the simplified framework called the Transition Navigation Model that tried to answer the question which factors explain the fact that after 15 years there is a substantial variation among countries in the movement towards a complete transformation to a liberal market economy with a high degree of open competition. The motivation behind the model was as follows: "...The reality of the historical process of transition in each country is far too interesting to be adequately captured by a simplified theory, and hence there cannot be perfect applicability of the model to each of the 27 countries... But the aim is to capture the most important common elements and to provide a model based on a consistent theory of economic behavior which allows prediction of how transition may develop further".[191]

Several hypotheses were tested. Among them were the following:

(H1) *Reform delay increases probability of state capture* (degree of state capture is negatively correlated with some measure of delay, such as time from regime change to start of reforms, or to achievement of a certain threshold);

(H2) *The greater state capture the more likely reforms are frozen* (TPI late-1990s is negatively correlated with degree of state capture; oligarchs are less supportive of reform parties than small entrepreneurs; oligarchs prefer easy rents to efficiency-based profits);

(H3) *Higher EU prospects reduce delay in reforms* (favorable 'offer' signals in early-1990s encourage early reforms; strong 'own demand' for membership drives early reforms regardless of signal from the EU; strong progress in reforms induces more favorable stance of EU; reluctance of EU in face of strong 'own demand' induces speed-up of reforms);

(H4) *Other miscellaneous hypotheses* (the stronger political commitment to liberal vision – shorter is delay; stronger independence/nationalism sentiment – delay is shorter unless violence results, where the liberalization is even slower).[192]

Havrylyshyn (2006) has found out that the explanatory factors were best thought of as three proximate causes of progress in transition: [193]

(i) *The length and intensity of debate on the 'navigation charts'* (the strategy of reform programs);

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[191] Havrylyshyn, O. (2006) pp. 133
[192] Havrylyshyn, O. (2006) pp. 147
[193] Havrylyshyn, O. (2006) pp. 136

(ii) *The vulnerability of a country to 'pirate raids' on state assets by rent-seeking interests;*

(iii) *The availability of 'a safe haven' such as EU memberships prospects disciplining the process to achieve a non-oligarchic transition.*

Author believes that these factors are not independent of each other. A popular hypothesis that the best predictor of economic progress is the outcome of the first elections is relevant here. The political commitment at the initial stage of transition process was described in the Section 3.1. "... The longer and more intense the debates on how far and how to transform the economy into a market-oriented one, the greater the opportunities for old and new vested interests to obtain large rents via continued distortions and also to concentrate the transfer of state assets in a few hands; the more concentrated the new ownership the slower will be subsequent stages of liberalization and the less likely the development of new entrepreneurial activity... This is because of the vested-interest principle that capitalists prefer less competition, not more... In a word oligarch capitalists behave optimally when they oppose full liberalization, democratization and rule-of-law".[194] This concept is connected to the 'transition frozen' (TF) view described in the Section 1.2. It is not surprising to suppose that massive rent-seeking can lead to a general state capture by powerful oligarchs. State capture was defined by Omelyanchuk (2001) as a "...Systematic activity of individuals of groups to influence to their own advantage the activity of the principle state institutions using nominally legal mechanisms and to influence to their own advantage the activity of the high level politicians as the result of illicit and non-transparent provision of private benefits to them".[195]

Simultaneously, countries are divided into four categories according to the degree of state capture and oligarchic development. The first group of countries consists actually of captured states with a high degree of concentrated ownership in a few hands, and with a very powerful 'economic oligarchy' able to capture state policy and virtually determine elections outcome, as in Kazakhstan and Russia. Then, there are partial oligarchies with an intermediate situation, so, with a considerable degree of oligarchic development, but declining in recent years, so with a state capture less complete – including Croatia. The third group consists of countries that have largely avoided the development of an oligarchic concentration of power strong enough to virtually determine state policy and elections outcome, as the Czech Republic and Estonia. Croatia is actually on the way of joining this category. Finally, in several countries market transformation has not finished far enough to result in any significant change in elite-power structure. In Belarus, for example, the original *nomenklatura* and its role changed insignificantly, except for taking advantage of also becoming a capital-owning class in the margin where

[194] Havrylyshyn, O. (2006) pp. 136
[195] Omelyanchuk, O. (2001) pp. 8

privatization has occurred. But the role of state guidance in the economy remains dominant. Consequently, this last group is out of the scope of the model, because there has been too little change in economic and political structures.

Havrylyshyn (2006) starts the analysis with the illustration of interactions of variables in the model by comparing the first, state capture group in a vicious circle of oligarchic development and the third competitive market group in a virtuous circle that avoids the extreme effects of oligarchic development.[196] The countries that are not yet clearly in the state capture or competitive-market categories comprise the intermediate groups. In the case of state captured group, the reforms are assumed to be delayed or extremely slow due to the historical continuity of anti-reform governments, the lack of external pressure such as mutual understanding with the EU (with a high probability of EU membership), a consensus in new nations that state-building takes priority over economic transformation, or even a sincere intellectual conviction that market reforms are not the optimal strategy in the long-run. Author describes two general results of correlation between the strategy of reform (timing, speed and sequencing) and state capture. The first is called 'Type A' with the high vulnerability to rent-seeking. Those countries pursuing gradual reforms and those experiencing an unsustained big-bang belong to this type; Russia and Kazakhstan are representatives. The second type is defined as 'Type B' with the low vulnerability to rent-seeking. Croatia, the Czech Republic and Estonia with either an advanced start (with a subsequent steady progress) in reforms or a sustained big-bang approach belong to this type of state capture. Both situations are illustrated in the Figure 3.3.[197]

In the type A, the formal right of private activity comes early, but other reform elements are delayed for a year or more. Author thinks that they come in the following sequence: "...Partial price liberalization excluding key raw materials, energy and some consumer items; partial liberalization of external trade; small-scale privatization; financial stabilization based on gradual tightening of fiscal, monetary and firm credit policies; limited institutional changes such as formal anti-monopoly laws; large-scale privatization".[198] What is common to the group is that countries experienced a very long delay of the reformation of the economic and political institutions which stimulate small enterprises, as simplification of licensing and tax regulation and equal access to transparent commercial adjustment process. Such a combination resulted in a rapid increase of rent opportunities and an extended period for accumulating considerable wealth from these rents prior to the sales of the very large state firms.

"...In the first few years (1989-1992), rents were easy to generate in the post-Soviet countries, but they were limited because the economy was still too much state-owned, and the

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[196] See Figure 3.2 pp. 104
[197] See Figure 3.3 pp. 105
[198] Havrylyshyn, O. (2006) pp. 182

lack of early stabilization sharply reduced the economic base for these rents... But once small-scale privatization added to the real assets available for purchase and stabilization began to take hold, the rent potential took off, and continued to rise as large-scale privatization provided the new capitalist class an even greater base for profit-making... At some point (notionally 12-14 years) a maximum level of rents is achieved, by which time the massive privatizations led to a highly concentrated ownership structure because the number of individuals allowed insider privileges was necessary small... If liberalizing reforms were to continue, with elimination of all price and regulatory distortions, removal of barriers to entry and establishment of a level rule-of-law playing field, the potential rents would begin to shrink and eventually approach very low levels again... It is precisely to prevent this decline in rents and maintain a status quo near the maximum that the largest rent-seekers, with enough financial power to wield great influence, put on the mantle of 'oligarch' and to go beyond lobbying governments to controlling them and 'freezing' the transition at a partially-liberalized state".[199]

The countries belonging to the 'Type B' (namely the Czech Republic, Croatia and Estonia) have experienced low rents. The strategy of reforms started similarly to that of high rents states, however the main difference vis-à-vis 'Type A' is that: "...Widespread liberalization followed very soon after and over a short period: quick stabilization, extensive price liberalization including for key raw materials, small-scale privatization, and institutional changes encoded in commercial codes... The result was that while the rent curve rose, at first perhaps even more sharply than in the 'Type A', it very soon reached an inflection point in the year 3-4 after which the opportunities were rapidly curtailed by the removed distortions underlying insider arbitrage and closing off the various state privileges of explicit and implicit subsidies, monopoly licensing and so on... Rent opportunities reached an early and low-level peak and continued to decline as the increasingly open and competitive environment limited any excess profits or rents".[200] Besides, the equal-access and transparent privatization of large-scale enterprises virtually shut the door to massive capture of the state by the 'oligarchs' (irresponsible rule by small groups according to Encyclopedia Britannica)[201]. Generally speaking, Central Europe minimized rent-seeking activities early by quickly reducing the major distortions of government policy (that could provide the opportunities for privilege-based profit-making). At the same time Croatia has fell behind and was catching up much later. It had a high level of market liberalization progress, but the insider dealings for privatization created some motivation towards state capture. This was however decreased and coped with by the new government in 2000, determined to change Croatia's image in Europe and start the process of EU membership.

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[199] Havrylyshyn, O. (2006) pp. 183
[200] Havrylyshyn, O. (2006) pp. 184
[201] Encyclopedia Britannica: "*Oligarchy*" (2006) pp. 31

To put it differently, the list of world billionaires by *Forbes* (2005) gives interesting findings. So, there is only one billionaire with the residence in the Czech Republic, while in Russia there are as many as 26 with GDP being only 7 times bigger.[202] There are 4 billionaires in Kazakhstan and none in Estonia and Croatia. Belarus is not mentioned. This fact clearly proves that the redistribution of wealth was much more 'honest' and transparent in Central Europe, and even Southern-Eastern Europe and Baltics (with the problem of high level of rent-seeking presumed throughout the first decade of the transition), in comparison to the countries of the FSU. However, the paradox lies in the fact that Baltic states were the part of the Soviet Union too, but performed much better in terms of equal wealth distribution (for example, GINI index in Central Europe varied from 24 to 31 percent in 1998-2001, and in Baltic states it was in the range between 32 and 40 percent, while it ranged from 30 to 60 percent in Russia and Kazakhstan according to various estimates).[203] So, being a FSU country does not necessarily imply that the level of state capture, administrative corruption and influence is visibly higher than in the former satellites of the USSR in the Central Europe.

Another fundamental factor behind the success of the transition is the possibility of EU membership according to Havrylyshyn (2006). The EU has responded almost immediately to the signals of the USSR collapse, so already at the G-7 Summit (1990), Chancellor Kohl insisted on inclusion of a reference to East European integration. More precisely, he claimed to ask the European Commission to take the necessary initiatives and to associate all interested countries. The initial reaction of the Commission was in the establishment of a PHARE program of economic assistance to Central Europe. Plus, in the 1989 the Statement of the EU Strasbourg Summit described the official position towards the newly independent post-Socialist Europe: "...The Community has taken the necessary decisions to strengthen its co-operation... with States which intend their founding principles to be democracy pluralism and the rule-of-law... It will continue its examination of the appropriate forms of Association with the countries which are pursuing the path of economic and political reform".[204] The intention behind the process was surely in the possible membership in the Union. Three important principles of the Association process were created. First, the integration into Europe was to be stepwise and flexible; it was conditional on a country's progress along democratic and economic dimensions (mainly the Maastricht criteria described in the Section 3.2.2); and, finally, the accession did not automatically follow. The effect of potential EU membership can be separated into two parts: 'the beacon effect' attracting the country's citizens (attracting with its calmer, richer and more

[202] Forbes: "Special Issue: Billionaires" (2005) pp. 1-5
[203] Havrylyshyn, O. (2006) pp. 97
[204] Papadimitriou, D. (2002) pp. 30-35

democratic waters) and the navigation chart effect (the *Acquis Communautaire* concrete instructions required to transform political and economic institutions).

There is a debate in the scientific circles of whether the 'variable' EU membership prospect might be considered exogenous (not determined by the other variables of the model but simply given from the outside) or endogenous (caused by one or several variables of the model). The degree of exogeneity vs. endogeinity of EU prospects varied in different countries.

Taking into account that among the six countries considered only the Czech Republic and Estonia became members of the EU in 2004, it is visible that there were significant differences in regional developments in this perspective. CIS countries, for example, seem to be affected by this factor only in a minor manner. But there were differences of the role of the factor even between the Czech Republic and Estonia. In the former case a larger role was played not only by the demand side (from the Czech Republic), but also on the supply side (offer from the EU itself) of the EU membership. The country in this sense was enticed to move forward by the formal and informal nature of such an offer and could be rewarded with many desired wishes, as the political and symbolic value of an early signing of the Europe Agreements; its immediate economic benefits; an early start on accession negotiation; generally positive annual reports by the EC; and an assured accession in the first wave of Eastern enlargement. Similarly, the free-trade part of the agreements helped to stimulate an export boom to the EU and a shift in trade patterns much earlier than in the FSU. What is extremely important is that, according to Havrylyshyn (2006), "... The stronger signal of the agreements and generally positive messages of steady progress in the annual EC reports greatly improved the region's reputation both in international forums and among foreign capital investors... The high level of FDI per capita in the early candidates is evident".[205] At the same time Havrylyshyn (2004) shows in a regression analysis that the prospect of EU membership was as important to foreign investors, and in particular it is this factor rather than TPI differences that explains the wide gulf of FDI per capita between prospective members and those with no such prospects in the near future. De Larosiere (2005) has summarized the economic performance of the country in prior to accession. Hence, the growth has been reaccelerating from 1.5% in 2002 to 4.4% in 2004, inflation was under control, the budget deficit stayed at a high level until 2003 (about 6% on average in 2001-2003) with a subsequent reduction to 3%, and a rather high level of public debt to GDP (around 18% in 2000).[206]

Estonia, in contrast, was not that much welcomed to join the EU at the initial stage of transition. The only positive signal was that Baltic States were included into the PHARE

[205] Havrylyshyn, O. (2006) pp. 208-209
[206] De Larosiere, M.J. (2005) pp. 5

program of assistance for Central Europe and not into the TACIS program designed from the rest of the FSU countries. Even though there was no a clear EU membership enticement at the beginning of transition, Estonia still showed the extremely high motivation and thus in the period 1992-1995 tried harder and essentially caught up to the Czech Republic by 1995 on the TPI measure of economic transformation. As early as 1991 there is evidence that the country oriented its legislation and policy formulation towards the EU membership goal.[207] For instance, a joint declaration between the presidents of three Baltic States in 1993 (calling on 'EU countries to initiate negotiations concerning the granting of associate member status') was accompanied by the public statements highlighting the importance of integration with the EU as a part of a guarantee of the country's security.[208] Even though the country was a subject to careful monitoring by the Commission, it was able to catch up rapidly and in 1997 the accession negotiations were open. In terms of economic development, the country performed rather stably since 2000: the annual growth accounted for 6-8%, inflation under control (1.5 – 3%), near balance fiscal position, and a low public debt of 5% of GDP.

For Croatia the EU membership factor had a special effect. The country was excluded at the beginning despite the advanced level of economic reforms, market operations, and steady progress, because of European concerns about war practices and democratic violations. There was a strong commitment to the EU within the society, but as long as the war president Tudjman was alive, any efforts by opposition political forces to win the elections were actually of the zero effect, and the prospects of future membership in the European Union were of the lesser significance. With the election win of Mesic in the 2000 elections, the discussions about the possibility of the membership started immediately, resulting in a *'Stabilization and Association Agreement'* in May 2001 and a European Agreement in June 2004.[209] So, it seems that at the initial stage of transition the country found itself in the situation similar to that of Estonia (without the clear 'invitation' from the EU), and the war conflict has diminished the commitment to a market economy and a paused the reforms implementation by several years. The result was that the country is still not the member of the EU.

Thus, the countries have been divided into three broad categories according to the strength of the initial 'offer' of membership from the EU: the strong initial offer was experienced in the Czech Republic, while the moderate one was faced by Estonia and Croatia and the other countries of the FSU having a zero/weak initial offer by EU (due either to the geographical or political reasons). Havrylyshyn (2006) summarizes on the EU membership factor: "... [It] clearly played a very large role in determining the rapidity of initial reform actions, in the pace

[207] Havrylyshyn, O. (2006) pp. 209
[208] Park, A. (1995) pp. 33
[209] Havrylyshyn, O. (2006) pp. 212

and steadfastness of political and economic liberalization, and on the final outcome after about 15 years… The EU invitation came in varying strengths, it came sometimes earlier, sometimes later, it came as reward for self-generated liberalization in some countries… But, also, it was not a force unto itself, but was intertwined with the internal push to liberalization which was higher the greater the degree of a non-aggressive national vision, and the greater the commitment of society and its leaders to liberalism".[210] Moreover, it seems that in the case of the Czech Republic the EU membership factor was exogenous, in contrast to Estonia and Croatia, where the factor was surely endogenous (they were able to 'impress' the EU with their rapid policy reforms).

As of the other international organizations that could have an impact on the success of transition (except the EU), NATO, the WTO, International financial institutions – IFIs (particularly the WB, the IMF, the EBRD, and regional trade or common market arrangements) are traditionally taken into consideration. However, their impact is significantly lower than that of the EU accession. Author believes that "… One must conclude that no alternatives come close to having the effect of the EU membership… NATO simply has no mechanisms for leveraging policy on economic and democratic dimensions… The IFIs when applying program conditionality may approximate for a time the effect of the EU, but their influence is far more limited if a member does not need or want financing and therefore does not enter into a programme-conditionality relation… The WTO has a very focused influence on trade liberalization, that is often limited, but not on ay other dimension of reform… Regional trade arrangements are even less important… It bears repeating that various EU cooperation arrangements which explicitly exclude membership as a possible end-point are also of limited impact".[211]

What are the conclusions out of the Transition model by Havrylyshyn (2006)? First, the degree to which rent-seeking interests can be successful in their efforts to influence government policies varied, so not all the post-communist states experienced the extreme degree of lobbying that resulted in dominant state capture including the ability to determine results of nominally-free elections. The strength of desire of future EU membership is one of the factors playing against vested interests, because it requires implementation of many liberalization measures that limit the opportunities for rent-seeking. Then, the interplay of these factors leads to two different dimensions. First, the delays of reforms may begin a vicious cycle, but rapid reforms lead to virtuous cycle. Delays may be partly due to the low EU membership prospects or desire, but it creates greater opportunity for rent-seeking, allowing rapid accumulation of wealth especially be

[210] Havrylyshyn, O. (2006) pp. 225
[211] Havrylyshyn, O. (2006) pp. 220

insiders. Then their natural desire would be to maintain a status quo ('TF' paradigm) which turns back with limited reforms. In contrast, the countries of the Central Europe pursuing a quick start of liberalization have shortened a period of distorted subsidies, price and administrative regulations and thus prevented any rent-seeking activities from attaining the magnitudes of the captured states. Notwithstanding the fact that privatization was not transparent in all cases, the degree of liberality and competitiveness in the markets was still high enough to limit the damages of insider problems. Author insists that "... In sum, none of these three determinants alone explains the final outcome one sees for each country in 2004, but together they tell a story that is relatively uncomplicated but still compelling... Several testable hypotheses are derived from this navigation paradigm... Some of them give very strong results, others are weaker as measuring a variable such as prospect of EU membership is difficult, but in all cases the results are consistent with these hypotheses".[212]

4. Summing up

The first aspect worth mentioning when summarizing on the developments in the post-Socialist area is the determination of whether the transition is over throughout the region. As early as in 1993 the Czech Prime Minister Vacláv Klaus proclaimed the completion of transition. However, within a few years the country faced a crisis the causes of which are to be found in an incomplete transition towards a market economy.[213] Marie Lavigne points out in her lecture that the determination of when transition is over will clearly be shaped by the biases of those who are judging, and so it is important to know who those judges are. She responds directly: "I think the question is unanswerable." But, she offers another reply: transition is over for the CEE countries when they become members of the EU.[214] This answer is important to consider because it is obvious to many people in Europe, but Lavigne deems it unworkable because the EU conditions are vague and unequally applied. Although she does not offer her own criteria for the end of transition, Lavigne anyway concludes that it is not over yet. For the countries of the CIS the forecast is more drastic. While some countries as Russia and Kazakhstan find themselves still in the middle position towards a complete transition, Belarus (being a hard delayer) stands almost at the start position.

As considered in Brown (1999), the answer of Gelb was straightaway: "Transition is over when the problems and the policy issues confronted by today's 'transition countries' resemble

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[212] Havrylyshyn, O. (2006) pp. 270
[213] Hare, H.W. (2004) pp. 9
[214] Brown, A.N. (1999) pp. 5-8

those faced by other countries at similar levels of development."[215] He further stated that no matter how this level is defined, the transition countries are not there yet. Aslund, in contrast, measured the end of transition according to the reduction of rent-seeking, which reflects a variety of institutional reforms. According to this standard, he concluded that transition is over in a few countries. Kornai answered this question with the most precision. He believes that the transition is over when three particular criteria are met. First, the communist party no longer has monopoly power. Secondly, the dominant part of the means of production is privately owned. Thirdly, the market is the dominant coordinator of economic activities. Svejnar presented two conditions for transition to be over: when central planning is abolished, and when an efficiently functioning market system has taken its place. According to these conditions, he concluded that transition is not over in any of the considered economies. The position of Brown (1999) puts that the transition is over when the organization of production reaches a long-run, market equilibrium. Finally, as the World Development Report (1997) states: "… Long-term stagnation and rising poverty… cannot be ruled out for some countries".[216] In this sense, the transition may actually never come to its end.

After 10 years of transition the countries find themselves at the different levels of economic development. The recent growth rates and performance can be analyzed on the convergence with the EU levels. In 2004, the annual GDP growth was higher in transition countries, than in the EU. Hence, it was 4% in the Czech Republic and Croatia; even 8% in Estonia and Belarus; 7% in Russia, and 9% in Kazakhstan, in contrast to 2% in the European Monetary Union area.[217] Notwithstanding stable growth tendencies in the Central Europe, Baltics and South-Eastern Europe and the resurgence of growth after 1999 in moderate CIS members, still the differences in welfare between economies in transition and Western Europe remain enormous.

4.1. Future prospects and policy implications

"Forecasting is very difficult – especially for the future".

Mark Twain

Experts have tried to access in how many years the various countries in transition might reach the Western European level. The estimates, according to Lavigne (1999), range from at least twenty years to several decades. The Bretton Woods institutions usually link the duration of catching-up with two sets of variables. The first set is addressed to transformation process itself and assumes that the faster-growing countries are those who were quickest to complete

[215] Brown, A.N. (1999) pp. 9
[216] WB: "*The State in a Changing World…*" (1997) pp. 147
[217] *World Development Indicators* database

stabilization and liberalization, for example in Fisher et al. (1996). The second set of variables is derived from standard neo-classical and endogenous growth models (considering investment ratio, government consumption in GDP and human capital indicators). Using several such models Fisher et al. (1998) come to the conclusion that the CEECs would need on average 30 years to converge to the per capita income level of the three lowest income countries in the European Union, with annual rates of growth in the range from 4.5 to 6% (assuming that the EU low-income countries would grow by an annual rate of 3%). "... [However] Such estimates do not take into account external shocks, reversals in policies and other unforeseeable events as they are based on an 'all other things being equal' assumption".[218]

The first systematic analysis of growth prospects of transition economies has appeared in the IMF's *World Economic Outlook* (1996). It stimulated the effects of lowering the share of public expenditures (except on education) to 15% of GDP and of raising investment rates to 30% of GDP. The same approach was designed by Fisher, Sahay and Vegh (1997). Authors used coefficients from Barro (1991) and Levine and Renelt (1992) and cross-sectional data from 15 transition economies to forecast GDP and per capita growth rates. Two exercises were conducted. The first investigated the consequences of lowering government consumption from current levels to 10% of GDP (in terms of number of years t needed to reach current OECD income levels). The second focused on the impact of raising the investment rate to 30% of GDP from current levels on growth. In subsequent work (1998), the authors analyze a smaller sample of transition economies (CEE and Baltic countries) to generate their catching-up prospects with the European Union. They carried out two simulations to determine the number of years needed to these transition economies to converge to the income levels of the three 'low-income' EU countries, namely Greece, Portugal and Spain (assuming that the latter will grow annually at 2% rate).

All the studies mentioned above found that these changes would increase growth substantially.[219] "... While government consumption at the previous rates was not sustainable and must have affected growth negatively, it is becoming increasingly clear that sharp reductions in expenditures on the scale seen in some of the transition economies may be adversely affecting the reform process... Indeed, it is likely that growth would be enhanced by more public spending on building market-based institutions, improving the quality of government administration, and setting up a social safety net".[220] As of the role of the investment, authors believe that "... The key to rapid growth in the transition economies is adopting policies that promote investment... While many of the transition economies have traditionally high investment ratios, the efficiency

[218] Lavigne, M. (1999) pp. 277
[219] Campos, N.F. (2000) pp. 5-6
[220] Fisher, S., R. Sahay and C. Vegh (1998) pp. 27

of the capital stock has typically been low... Hence, policies should focus not only on increasing the level of investment, but also on improving its efficiency."[221]

Havlik (1996) assumed a growth rate differential in real GDP per capita of 3% points between the CEEC-7 and the European Union average, trying to answer the question how many years will the CEEC-7 countries need to catch-up with the EU, or, more likely, with its poorer members (given the 1995 levels of real per capita GDP). The author concluded that "... Convergence between the two most advanced CEEC countries and Spain... could not happen before 2005... For the other CEEC members to converge to the EU average by 2010 would require a growth differential of more than 5 per cent, a highly unrealistic assumption".[222] One important contribution to this literature is made in the European Bank for Reconstruction and Development's "*Transition Report*" (1997) (Chapter 6). This report suggested a revision of the forecasted long-run growth rates: even for those transition economies with relatively high-quality institutions (and for which institutional data are available), the absence of further institutional change should lower long-term growth rates by 1.5% points.

The dominant scientific position towards the transition gaps and policy challenges was expressed in IMF's *World Economic Outlook* (2000): "... To catch up, transition economies need to both pursue sound macroeconomic policies and to make progress toward completing structural reforms and building the institutions required to underpin a market economy, while recognizing realistic constraints on their implementation capacity... A well-focused policy agenda is especially important for countries that have not yet managed to embark on a path of sustained growth and convergence... In these countries, the challenge is to reinvigorate the reform process in the face of limited institutional capacities, the existence of vested interests, serious governance problems ... and widespread arrears and fiscal problems... Unless reform efforts are focused and strengthened, these countries face the prospect of remaining in an incomplete transformation trap, where low domestic saving and investment, a lack of enterprise restructuring and concomitant inefficiencies, pervasive problems with barter and arrears, lack of competition, limited foreign direct investment, and capital outflows create a vicious circle, depriving them from the opportunity to achieve higher growth, bring down inflation, and reduce the dependence on official external financing".[223] Deeper structural reforms in the EU accession group, including the Baltic States (that were initially part of the FSU), compared to Russia and other members of the CIS have led to a superior macroeconomic performance, providing testimony to the importance of such reforms for long-term perspective on the welfare.[224] It is

[221] Fisher, S., R. Sahay and C. Vegh (1998) pp. 33
[222] Havlik, P. (1996) pp. 42-44
[223] IMF: *"World Economic Outlook..."* (2000) pp. 121-122
[224] IMF: *"World Economic Outlook..."* (2000) pp. 130

actually believed that greater competition could play a significant role in supporting the reform process, because it can erode the economic rents associated with particular activities, lower the benefits to incumbents from the status quo and reduce the resources to oppose reforms. But, this requires providing a favorable business environment for small and medium-size enterprises, removing barriers to FDI and joint ventures, and developing markets for the trade of equity and control in firms where ownership has been transferred to insiders. On the other hand, the countries in the region would be surely influenced by the global market, where they participate rather intensively since the beginning of transition. Bilateral trade agreements, cross-border barter, and tolerance for external payment arrears continue to hamper trade diversification outside the region and should be phased out in favor of most-favored-nation-based trade (in those countries where this problem is actual). Private capital inflows can help to renew and expand the capital stock and close the technology gap with the advanced economies. FDI, particularly, is generally considered to be a stable and effective way to transfer productive capital and technical know-how from the advanced economies, and concentrated foreign ownership has been found to be the most successful in producing active enterprise restructuring in the transition economic system. Advanced economies can also play its role through elimination of trade barriers for products like textiles, steel, bulk chemicals, agricultural products and food stuff (areas in which the transition countries have a potential comparative advantage, especially in the cases of Belarus and Ukraine combined with a beneficial location). It is believed to have a stimulating effect on the trade linkages.

Another fundamental weakness of the transition process that has to be coped by the ruling governments is the corruption, which is the product of both the negative motivations (declining civil servants' salaries, lack of an appropriate social safety net) and the numerous opportunities to engage in corruption in countries with lax regulations. According to Lavigne (1999), "… The recipe would be economic liberalization and privatization along with the enforcement of prudential banking regulations and the reform of tax administration and of the civil service".[225] It can also rise from the process of transition itself. In the structural composition of the economy, several privatization methods are conducive to corruption. For example, Kaufmann and Siegelbaum (1996) argue that swift methods such as voucher privatization prevent corruption much more efficiently than gradual privatization in the form of direct sales or tenders. It can be argued, however, that what actually matters is the final outcome of privatization. Moreover, the Czech and Russian examples show that corruption and outright crime emerge after voucher privatization as well. This issue is of the extreme importance for the countries still not performed the main privatization (as Belarus).

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[225] Lavigne, M. (1999) pp. 275

Since there are different groups of countries (united by specific circumstances, as, for instance, the EU accession), the future policy implications differ accordingly. For those countries now tied by membership or advanced accession negotiations to the EU, future policy is less related to transition from socialism to the market and more related to the problems typical of middle-income emerging markets, with perhaps some institutional inadequacies still to be resolved. These are more the subject of developmental economics, public finances, monetary and exchange rate policies. There is some additional specificity related to the EU membership, according to Havrylyshyn (2006), such as the optimal timing of euro-adoption, but these two are not transition issues any longer. Besides, "...for countries less advanced in the transformation but highly likely to be put on a track to EU membership, the relevant transition issues (liberalization, privatization, institutional development) will be guided by the requisites of the negotiations of *Acquis* chapters, with limited room for deviation except perhaps on timing".[226]

On the other hand, for the countries finding themselves somewhere in the middle of the transition, several lessons from the CEE experience can be useful. First, the structural liberalization was done most successfully by those that moved early and fast, and privatization gave the best results when it was open and transparent. Consequently, the delay in the stabilization measures and structural reforms in several countries, while trying to save the nation from the transformation shock, undoubtedly caused more negative than positive effects: "...While it is important to develop good institutions, waiting for these to be in place is costly, and risks yet again creating the rent-seeking environment that has been so harmful in the region... It is important to move fast enough on liberalization to close up the various loopholes of price distortions and government regulations to minimize the rent opportunities".[227] Another policy implication for the transition economies still on the way towards 'healthy' market relations is in the method of large-scale privatization of state enterprises: "... The process of large-scale privatization can come early or late, but most important is that it be an open and transparent process that precludes those on the inside and/or well-connected individuals to access large state assets at bargain-basement prices...Such insider phenomena... [Causes] huge resentment in the population and erodes popular consensus for market reforms, and may lead to the creation of powerful financial interests who can capture the policies of the state".[228] Also, an underestimated aspect of a good transformation is the creation of a market and institutional environment that encourages new small business – is actually an area where many economic systems in transition behave ambivalently. In order to promote small and medium business, it requires a dramatic simplification of business licensing, taxation and regulation. At the same

[226] Havrylyshyn, O. (2006) pp. 273
[227] Ibid.
[228] Ibid.

time, the level of corruption in the newly emerged states seriously challenges the effectiveness of these measures.

Keeping in mind the assignment of several CIS countries into the state captured group (even though not the extreme cases of state capture), Havrylyshyn (2006) has also developed the possible policy implications for this category. According to the author, there are three types of possible policy actions proposed to reverse the capture of the state:

(i) Reverse privatization and reduce the power of oligarchs;

(ii) Restrict the power of oligarchs by anti-monopoly regulations and elimination of any subsidies and licenses;

(iii) Facilitate development of new and small-medium-sized enterprises as a political counterweight to the large economic entities.[229]

The first measure is the most risky and least advisable. It seems to be extremely popular in the political circles, where oligarchs are massively perceives as simple thieves. The approach seems to bring more harm than good in the long-run, because there is a great danger to have the reversal flawed by a re-privatization to another favored insider. Consequently, several conditions should be met to make the re-privatization beneficial: the number of cases should be limited; they should be selected very judiciously; and the situation where the people close to the government benefit from the action should be avoided. The second measure can be crucial as well. Both anti-monopoly regulations and elimination of subsidies can be the means thorough which the resistance to the influence of the oligarchs can be performed. The general conclusion is that "...Governments with some degree of independence and desire to work for the general good should go as far as they can in effective and sincere restrictions of oligarch power, even if it is slow-going".[230] The last policy proposed (facilitating the small business sector) is probably the most powerful of all approaches. It actually aims to ease the great bureaucratic and taxation burdens that this sector faces in most of transition economies. Author believes that these burdens are the reason the sector is so little developed compared even to the newly transformed CEE countries, and its limited development goes a long way to explain the weakness of civil society. The importance of having the strong small-enterprise sector lies in the fact that it not only tends to be the most innovative and dynamic part of any economy, but its members are the strongest proponents of transparency, factually, the proper rule-of-law. "... This approach is central to the future of the captured states where transition is stalled, where capitalism thrives only for the select few who function in a non-competitive and restricted market economy... Opening up the markets to new entrants and creating a level paying field of competition between big and small

[229] Havrylyshyn, O. (2006) pp. 274
[230] Havrylyshyn, O. (2006) pp. 275

will be the most powerful lever to transform these states into real market economies with capitalism for all".[231]

In sum, the developments in the region would undoubtedly depend on the actions of the particular politicians. Besides, the initially adopted strategies are hard to overcome. In the state captured cases the change is challenged mainly by the unwillingness of the ruling party to give up dominant positions. The same happens with the oligarchs (members of old *nomenklatura*). In a combination, these variables allow the long-standing delays in the transformation. In this scenario, the new EU members would be automatically saved from a high level of rent-seeking, the associate member as Croatia can develop enough to join the Union too (with the main help of FDI); but the forecast for the developments in the CIS region are less optimistic. Russia and Kazakhstan risk staying at the middle position with unequal distribution of wealth, unfair laws and regulations, and semi-transparent procedures. Belarus, at the condition of continuation of the current political leadership, is seen as an even worse economic performer. It has been simply captured at the initial stage of transition and the possibility to leave the vicious cycle and enter virtuous cycle of development is very weak. However, taking into account the arguments of the transition inevitable paradigm, it seems that the global democratizing forces will win over the frozen transition. In this scenario the current captured states would essentially go away from the massive rent-seeking and corruption, and the start would be given by the proper behavior in the international trade. Even Belarus hypothetically has the possibility to change the situation. The only really working method is the radical change of the ruling party – the practice of the 'Color Revolutions' (with the examples of Georgia's *Rose revolution*, Ukraine's *Orange revolution* and Kyrgyz Republic's *Tulips*). However, it should be remembered that each of these revolutions of color had the overwhelming common factor – the resentment of the population at the egregious abuse of political and economic power by the 'oligarch' circle. Moreover, the probabilities of analogous people-power revolutions in neighboring countries are hard to judge.

4. 2. Conclusions

Several conclusions can be drawn out of the divergent performance throughout the post-Socialist region of Eurasia. As it was already mentioned before, understanding the nature of divergence in the transition progress is critical for any country already experiencing the transformation of the state architecture or just preparing itself for the process. The topic is young and controversial. The principal debates of the 1990s regarding the post-Socialist transition covered: the speed of the reforms; best approach over privatization strategy; the sequencing and adequacy of development of market institutions and the rule-of-law; the relationship between

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[231] Havrylyshyn, O. (2006) pp. 276

market liberalization and democratization; the reasons for the unexpectedly large output fall; the large difference in reform and growth performance between Central Europe, Baltic States, and South-Eastern Europe on the one hand, and CIS countries on the other hand; the large social costs, rising inequality and increasing poverty incidence; and the comparison with China's less disruptive transition. Different schools of economic thought react differently to both reasons of the recession and methods of overcoming this challenge. Claiming that the transition recession is caused mainly by the non-optimal reallocation of resources, mainstream economists believe that the big-bang reforms scenario ("shock therapy") is the most suitable solution. A gradual transition is advocated by the alternative economics streams. Hence, post-Keynesians believe that the main reason behind the recession are declining consumer demand (as a result of stabilization measures) and the role of uncertainty; institutionalists stress the role of the increased transaction and information costs; evolutionists point to the *embeddness* of institutions; Mathematical models actually prove that the big-bang scenario is still better in terms of social costs to be paid; besides, the relatively successful example of China (which is frequently used as the main gradualist argument) seems to be unique due to the surplus of a cheap labor power, that the post-Socialist Eurasia states did not have in the course of their transition.

Whereas the economic recovery in the Central Europe, Baltic States, and partly South Eastern Europe was dynamic in its nature (as reflected in the level of economic performance); CIS countries seem to lag behind in their economic growth. In search for reasons for divergent outcomes, the comprehensive approach ('encyclopedic') combines many aspects of the process and so allows perceiving the situation more realistically. It advocates the role of the initial conditions and transition strategies. However, it has gaps in explanatory power, namely, it produces so many unique situations, that there is impossible to find commonalities between countries, and the same factor can act differently in different countries (for example, some rich and ethnically homogeneous countries score low).

The alternative approach by Havrylyshyn (2006) focuses on the effects of the delay in the reforms leading to proclivity to rent-seeking, state capture, and a frozen transition on the one hand; and "EU beacon" stimulating the catch-up and preventing the state capture by powerful oligarchs on the other hand. Actually, the result of Havrylyshyn's analysis is the negative correlation between these two factors, so that the desire of future EU membership plays against vested interests. The author has tested three hypotheses ((i) Reform delay increases probability of state capture; (ii) The greater the state capture, the more likely the reforms are frozen; (iii) Higher EU prospects reduce delay in reform), and all of them showed a strong correlation.

It is believed that the end of the transition has not surely come in the whole region, because the great differences in welfare still exist between transforming economies and Western

Europe, not even speaking about the CIS countries (however, commitment towards positive improvements were claimed recently). The average period to the possible convergence with the rest of the Europe varies from 20 years to several decades (under the assumption of government consumption below 10 percent of GDP and investment rate not less that 30 percent of GDP).

Answering the second question posted in this thesis ("Why the developments were divergent throughout the region?"), it can be said that the combination of several factors has determined the outcome. The impact of the initial conditions is undisputable. On the other hand, the policies implemented by the government seem to be the major determinants of the economic performance in the long-run. However, there were cases where the countries were able to catch up notwithstanding the negative initial conditions (for example Baltic states). On the other hand, there were cases where the positive initial conditions were not used properly and thus did not bring any valuable benefit. Thus, there must be something behind the whole course of reforms, which has determined the political commitment and the choice and implementation schedule of the reforms right at the beginning of the transition process. It is undoubtedly the possibility of the membership in the prosperous European Union that the CSB countries had received, in contrast to the CIS states. It seems that is has been the major determinant of either vicious cycle of oligarchic development (which at some point freezes the transition) or the virtuous cycle of fair market economy (which has been exactly promoted by the EU). Moreover, the analysis of future prospects concludes that the situation would preserve (the divergence between CSB countries and CIS countries), unless the captured states overcome the frozen transition progress under the *transition inevitable* paradigm by the promotion of the market relations, free competition, corporate governance and the rule-of-law.

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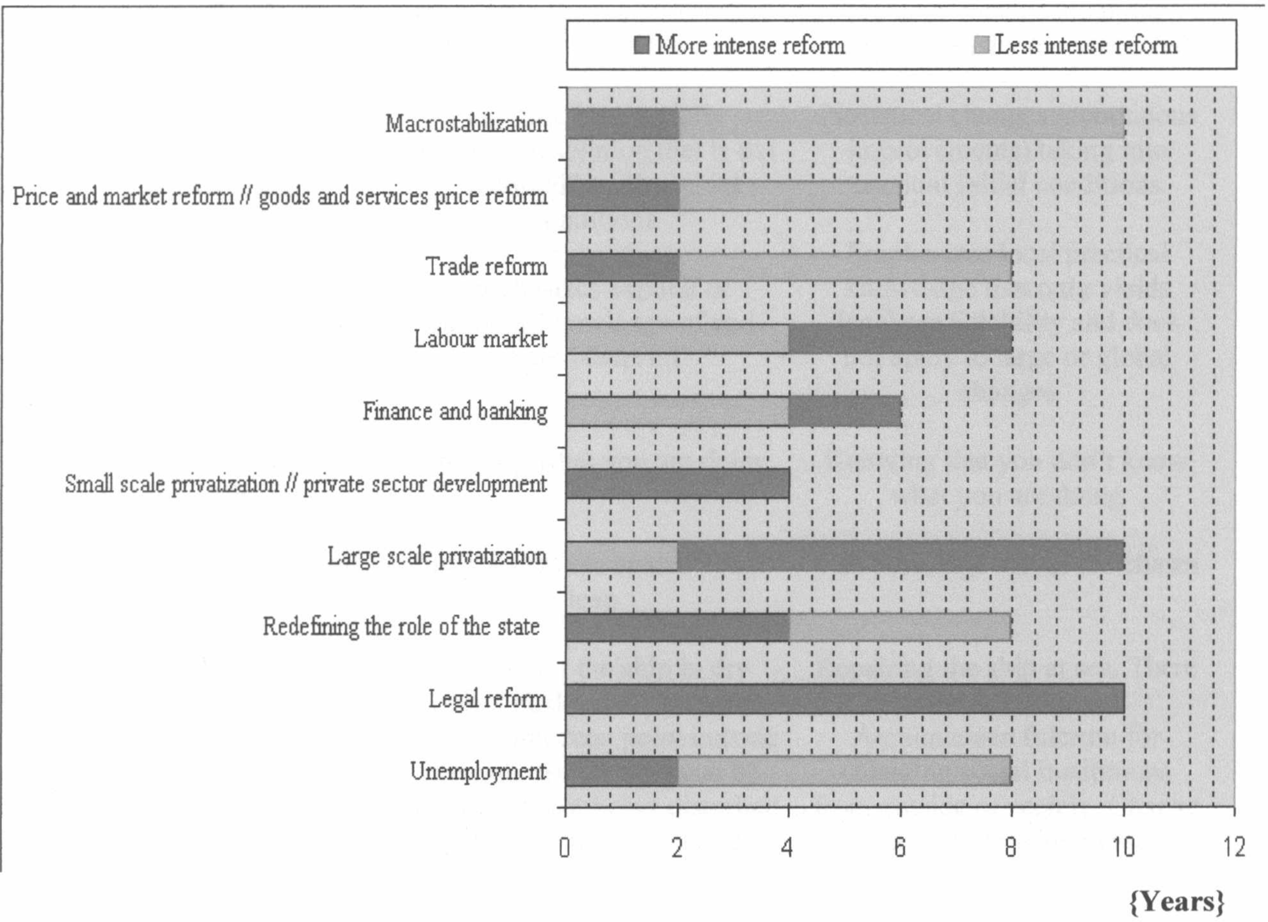
6. Tables and figures

Figure 1.1

Illustration of the Washington Consensus[232]



[232] Reproduced from Stanley Fisher and Alan Gelb, "The Process of Socialist Economic Transformation" , Journal of Economic Perspectives, vol. 5, no. 4, Fall 1991 by Havrylyshyn (2006): pp. 18

Table 1.1

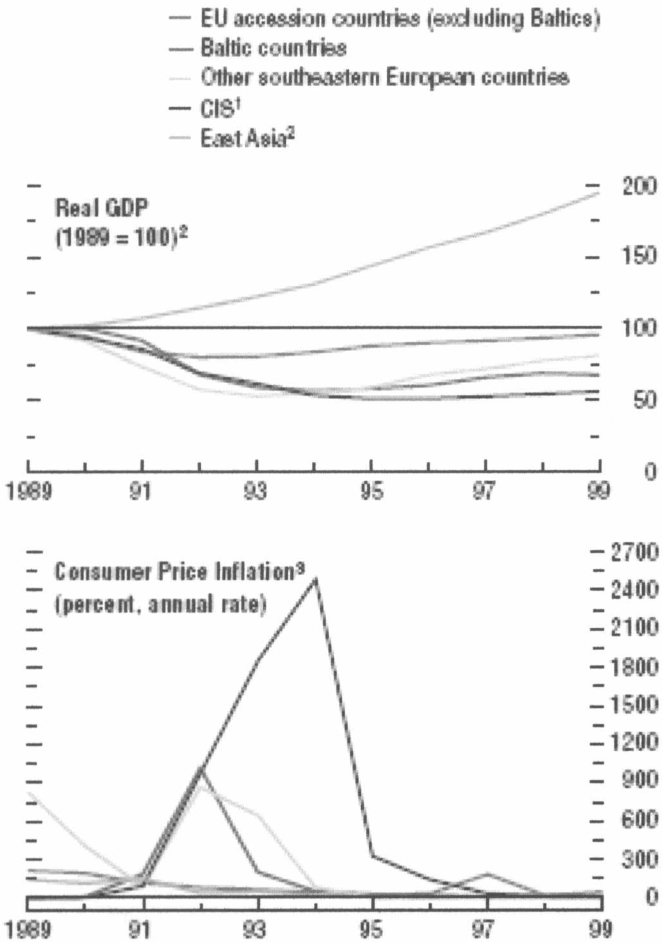
"Battle of Metaphors" by Joseph Stiglitz [233]

	Shock Therapy	Incrementalism
Continuity vs. Break	Discontinuous break or shock – razing the old social structure in order to build the new	Continuous change – trying to preserve social capital that cannot be easily reconstructed
Role of Initial Conditions	The first-best socially engineered solution that is not "distorted" by the initial conditions	Piecemeal changes (continuous improvements) taking into account initial conditions
Role of Knowledge	Emphasizes explicit or technical knowledge of end-state blueprint	Emphasizes local practical knowledge that only yields local predictability and does not apply to large or global changes
Knowledge Attitude	Knowing what you are doing	Knowing that you don't know what you are doing
Chasm Metaphor	Jump across the chasm in one leap	Build a bridge across the chasm
Repairing the Ship Metaphor	Rebuilding the ship in dry dock. The dry dock provides the Archimedean point outside the water so the ship can be rebuilt without being disturbed by the conditions at the sea	Repairing the ship at sea. There is no "dry dock" or Archimedean fulcrum for changing social institutions from outside of society. Change always starts with a given historical institutions
Transplanting the Tree Metaphor	All at once transplantation in a decisive manner to seize the benefits and get over the shock as quickly as possible	Preparing and wrapping the major roots one at a tine (nemawashi) to prevent shock to the whole system and improve chances of successful transplantation

[233] Stiglitz, J.E. (1999) pp. 23

Figure 2.1

Output and Inflation Performance during Transition [234]



[1]Data include Mongolia.

[2]Chart is adjusted for three east Asian countries whose transitions began prior to 1989. The first 11 years of transition for the following countries are as follows: China (1978–89), Lao P.D.R. (1986–97), and Vietnam (1986–97).

[3]The increase in the EU accession group's inflation, in 1997, is largely accounted for by the hyperinflation experienced in Bulgaria that year.

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[234] "World Economic Outlook", IMF (2000) pp. 95

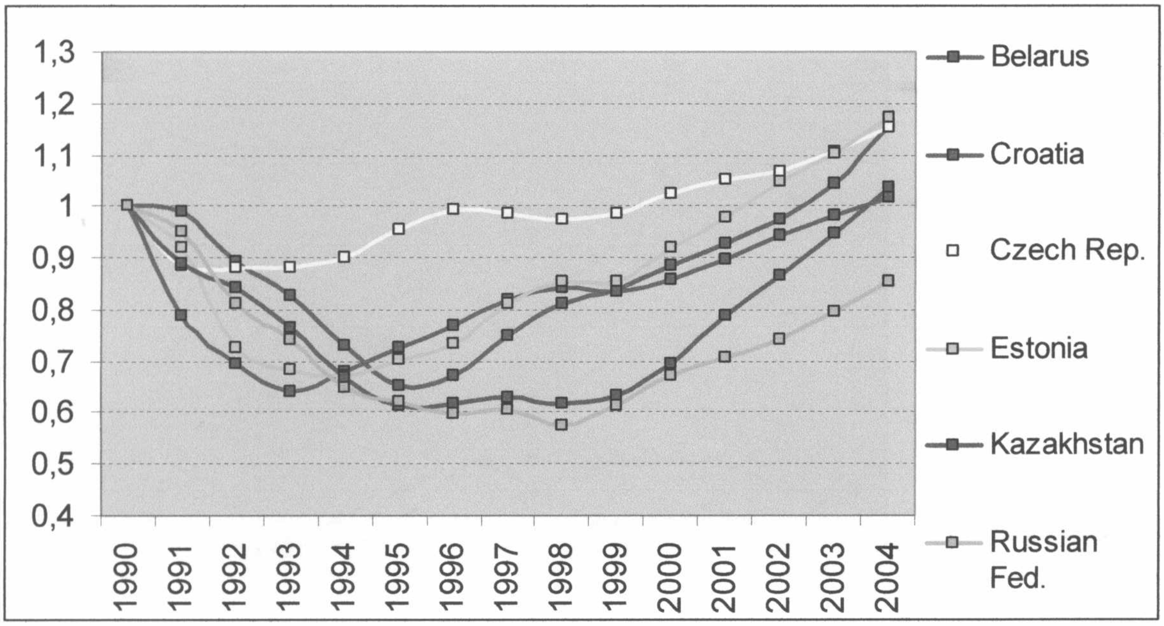
Figure 2.2

Evolution of GDP (constant 2000 US$) [235]

(in millions)

	1990	1992	1994	1996	1998	2000	2002	2004
Belarus	12,876	11,5	9,383	8,643	10,437	11,417	12,552	14,907
Croatia	21,503	14,981	14,587	16,504	18,071	18,427	20,249	21,896
Czech Rep.	54,397	47,833	48,925	53,989	52,982	55,707	58,029	62,612
Estonia	5,942	4,309	3,99	4,359	5,069	5,46	6,23	6,954
Kazakhstan	26,348	22,207	17,623	16,259	16,221	18,292	22,796	27,258
Russian Fed.	385,892	313,172	250,072	231,081	221,897	259,709	285,695	328,809

{Level*}



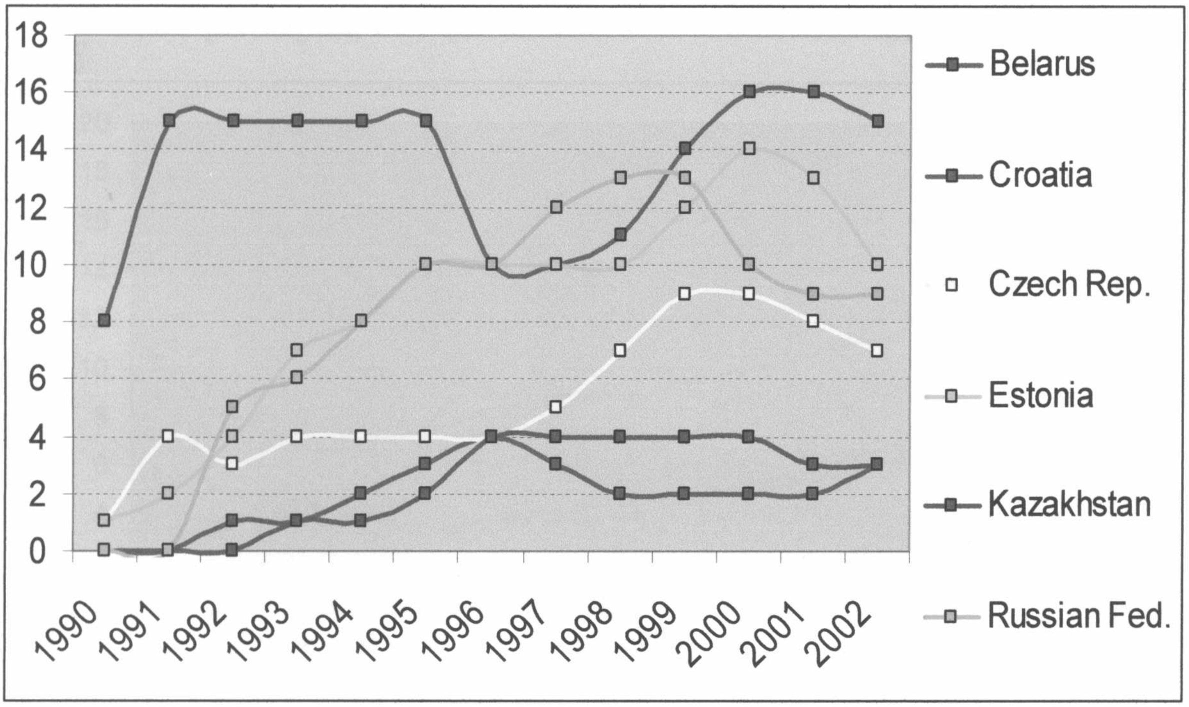
* Value at the start of transition (1990) = 1.00

[235] *World Development Indicators* database

Figure 2.3

Evolution of total unemployment (% of labor force) [236]

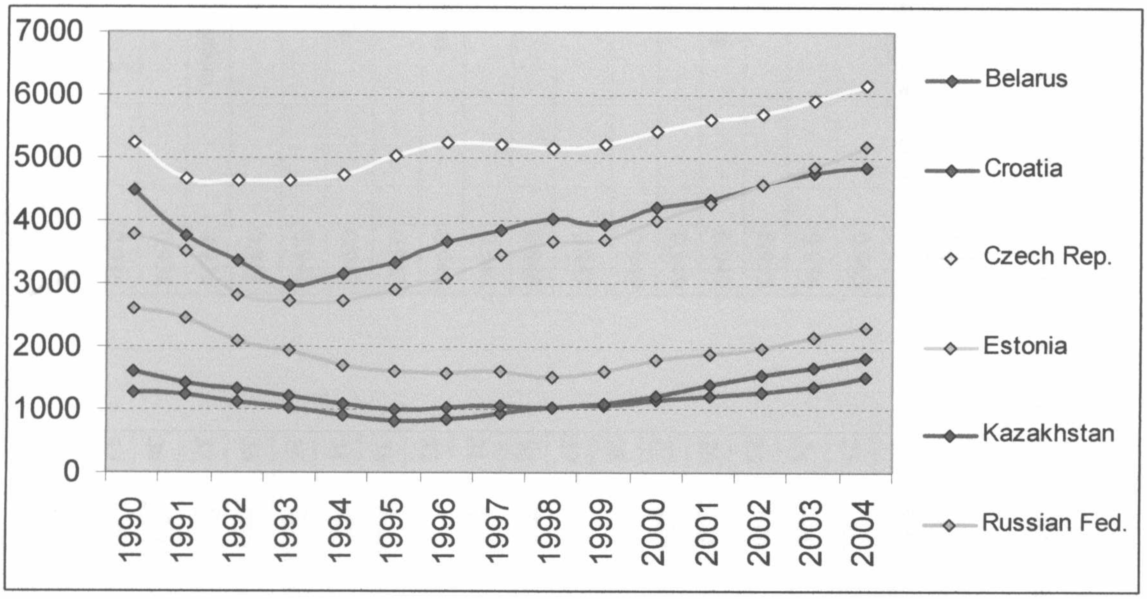
	1990	1992	1994	1996	1998	2000	2002
Belarus	..	1	2	4	2	2	3
Croatia	8	15	15	10	11	16	15
Czech Rep.	1	3	4	4	7	9	7
Estonia	1	4	8	10	10	14	10
Kazakhstan	..	0	1	4	4	4	3
Russian Fed.	..	5	8	10	13	10	9



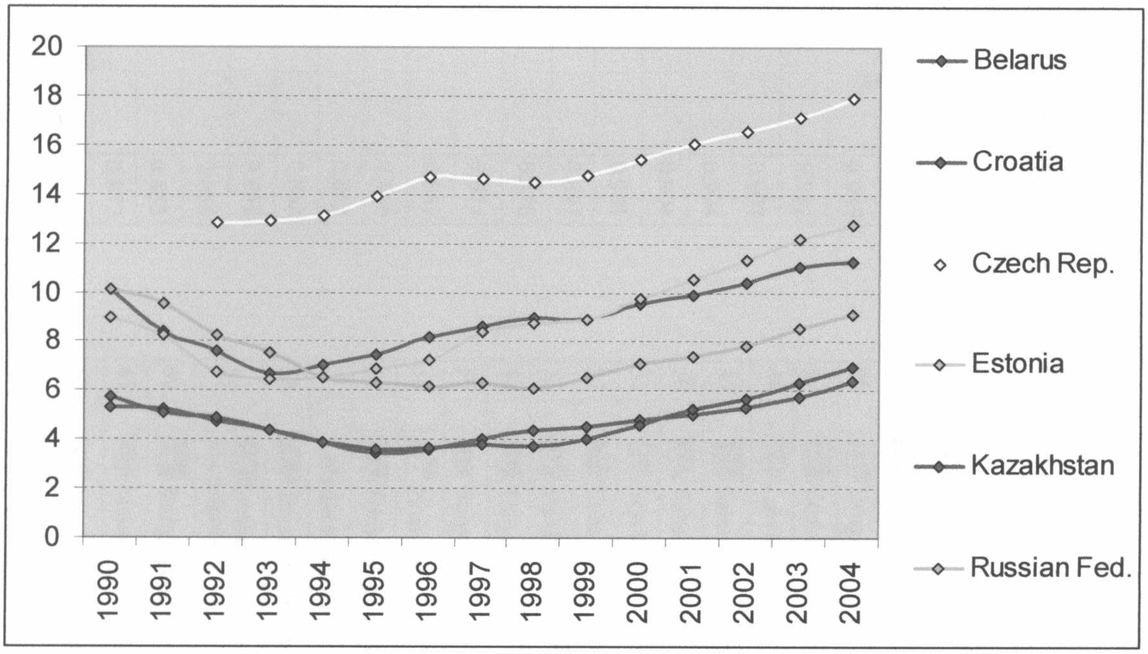
[236] *World Development Indicators* database

Figure 2.4 [237]

GDP per capita (constant 2000 US$)



GDP per capita, PPP (in thousands constant 2000 international $)



237 *World Development Indicators* database

Figure 2.5

List of First One Hundred Countries by Human Development Index (2003)

Rank	Country [238]	HDI
	High human development	
1	Norway	0.963
2	Iceland	0.956
3	Australia	0.955
4	Luxembourg	0.949
5	Canada	0.949
6	Sweden	0.949
7	Switzerland	0.947
8	Ireland	0.946
9	Belgium	0.945
10	United States	0.944
11	Japan	0.943
12	Netherlands	0.943
13	Finland	0.941
14	Denmark	0.941
15	United Kingdom	0.939
16	France	0.938
17	Austria	0.936
18	Italy	0.934
19	New Zealand	0.933
20	Germany	0.930
21	Spain	0.928
22	Hong Kong, China (SAR)*	0.916
23	Israel	0.915
24	Greece	0.912
25	Singapore	0.907
26	Slovenia	0.904
27	Portugal	0.904
28	Republic of Korea	0.901
29	Cyprus	0.891
30	Barbados	0.878
31	**Czech Republic**	**0.874**
32	Malta	0.867
33	Brunei Darussalam	0.866
34	Argentina	0.863
35	Hungary	0.862
36	Poland	0.858
37	Chile	0.854
38	**Estonia**	**0.853**
39	Lithuania	0.852
40	Qatar	0.849
41	United Arab Emirates	0.849
42	Slovakia	0.849
43	Bahrain	0.846
44	Kuwait	0.844
45	**Croatia**	**0.841**
46	Uruguay	0.840
47	Costa Rica	0.838
48	Latvia	0.836
49	Saint Kitts and Nevis	0.834
50	Bahamas	0.832
51	Seychelles	0.821
52	Cuba	0.817
53	Mexico	0.814
54	Tonga	0.810
55	Bulgaria	0.808
56	Panama	0.804
57	Trinidad and Tobago	0.801
	Medium human development	
58	Libyan Arab Jamahiriya	0.799
59	Former Yugoslav Republic of Macedonia	0.797
60	Antigua and Barbuda	0.797
61	Malaysia	0.796
62	**Russian Federation**	**0.795**
63	Brazil	0.792
64	Romania	0.792
65	Mauritius	0.791

[238] UN Development Programme Report (2005)

Figure 2.5 ***(continued)***

66	Grenada	0.787
67	**Belarus**	**0.786**
68	Bosnia and Herzegovina	0.786
69	Colombia	0.785
70	Dominica	0.783
71	Oman	0.781
72	Albania	0.780
73	Thailand	0.778
74	Samoa (Western)	0.776
75	Venezuela	0.772
76	Saint Lucia	0.772
77	Saudi Arabia	0.772
78	Ukraine	0.766
79	Peru	0.762
80	**Kazakhstan**	**0.761**
81	Lebanon	0.759
82	Ecuador	0.759
83	Armenia	0.759
84	Philippines	0.758
85	China	0.755
86	Suriname	0.755
87	Saint Vincent and the Grenadines	0.755
88	Paraguay	0.755
89	Tunisia	0.753
90	Jordan	0.753
91	Belize	0.753
92	Fiji	0.752
93	Sri Lanka	0.751
94	Turkey	0.750
95	Dominican Republic	0.749
96	Maldives	0.745
97	Turkmenistan	0.738
98	Jamaica	0.738
99	Islamic Republic of Iran	0.736
100	Georgia	0.732

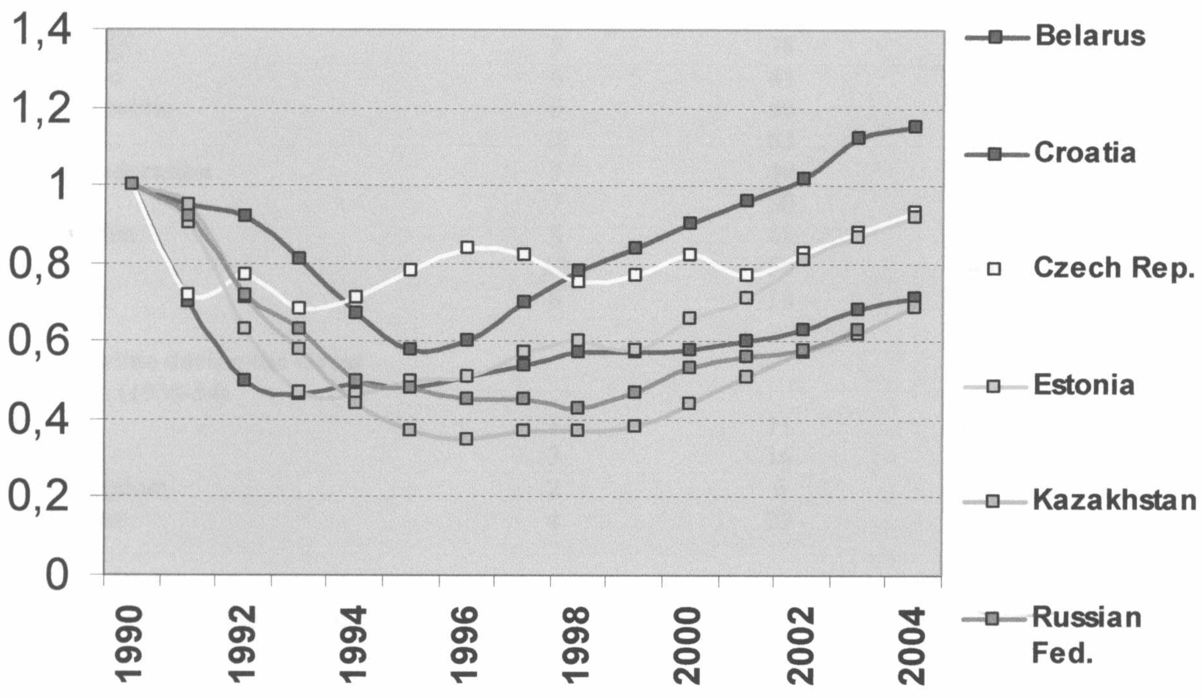
Figure 2.6

Evolution of industrial production, value added (constant 2000 US$) [239]

(in millions)

	1990	1992	1994	1996	1998	2000	2002	2004
Belarus	4.207	3.870	2.824	2.527	3.304	3.822	4.315	4.875
Croatia	7.757	3.930	3.868	3.992	4.442	4.520	4.947	5.552
Czech Rep.	24.007	18.576	17.064	20.183	18.138	19.738	20.039	22.556
Estonia	1.988	1.270	930	1.028	1.209	1.314	1.619	1.834
Kazakhstan	15.495	11.057	6.839	5.496	5.786	6.910	8.914	10.786
Russian Fed.	164.481	119.557	83.119	74..914	71.750	88.091	96.680	..

{Level*}



* Value at the start of transition (1990) = 1.00

[239] *World Development Indicators* database

Figure 2.7

Transition Recession [240]

Countries	Consecutive years of output decline	Cumulative output decline (percent)	Real GDP, 2000 (1990=100)
CSB[a]	**3,8**	**22,6**	**106,5**
Albania	3	33	110
Bulgaria	4	16	81
Croatia	**4**	**36**	**87**
Czech Republic	**3**	**12**	**99**
Estonia	**5**	**35**	**85**
Hungary	4	15	109
Latvia	6	51	61
Lithuania	5	44	67
Poland	2	6	112
Romania	3	21	144
Slovak Republic	4	23	82
Slovenia	3	14	105
CIS[a]	**6,5**	**50,5**	**62,7**
Armenia	4	63	67
Azerbaijan	6	60	55
Belarus	**6**	**35**	**88**
Georgia	5	78	29
Kazakhstan	**6**	**41**	**90**
Kyrgyz Republic	6	50	66
Moldova	7	63	35
Russian Federation	**7**	**40**	**64**
Tajikistan	7	50	48
Turkmenistan	8	48	76
Ukraine	10	59	43
Uzbekistan	6	18	95
Output decline during the Great Depression (1930-34)			
France	3	11	n.a.
Germany	3	16	n.a.
United Kingdom	2	6	n.a.
United States	4	27	n.a.

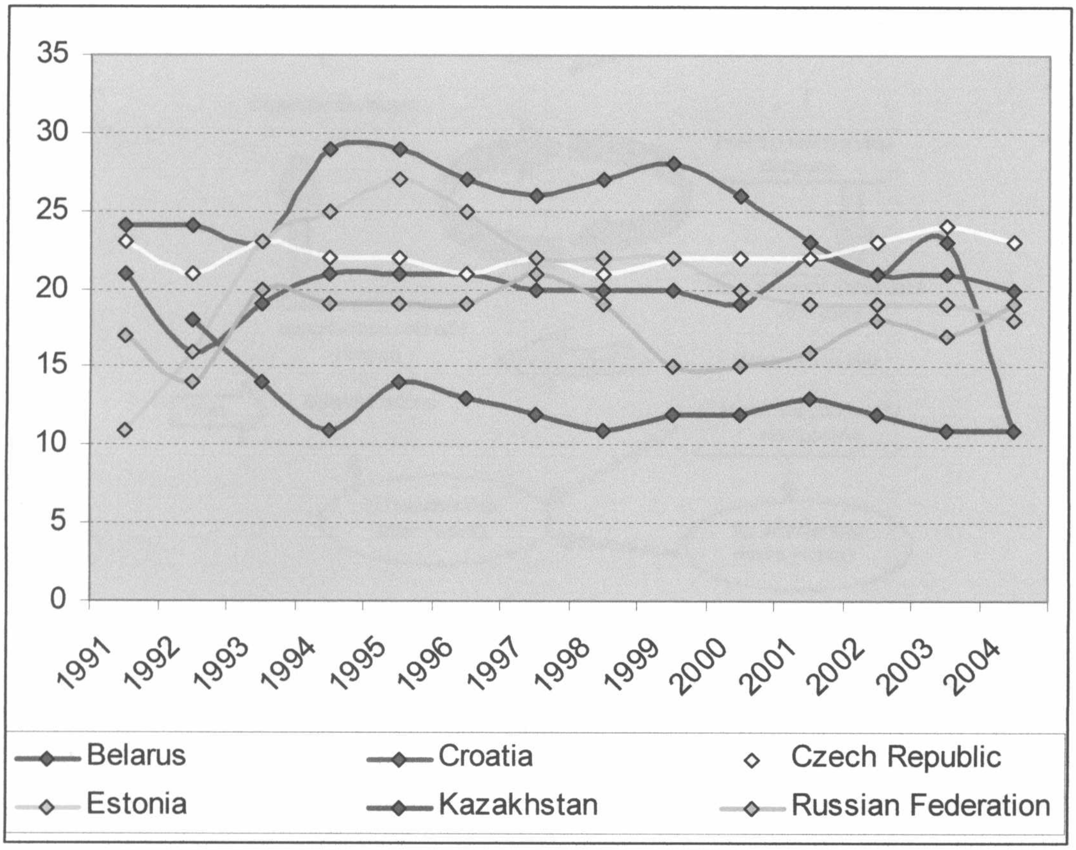
n.a. Not applicable

a. Simple average, except for the index of 1990 GDP, which shows population-weighted averages

[240] *"Transition. The First Ten Years"*, WB (2002) pp. 5

Figure 3.1

General government final consumption expenditure (% of GDP) [241]

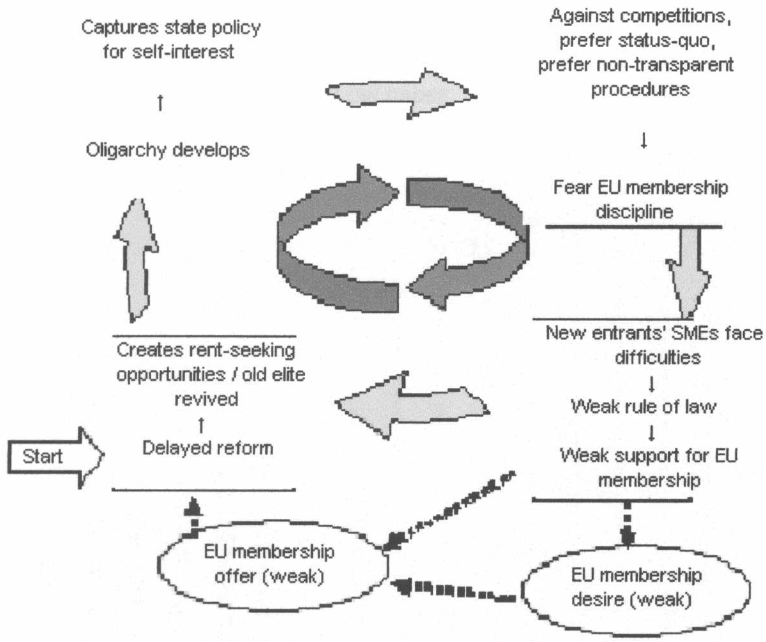


[241] *World Development Indicators* database

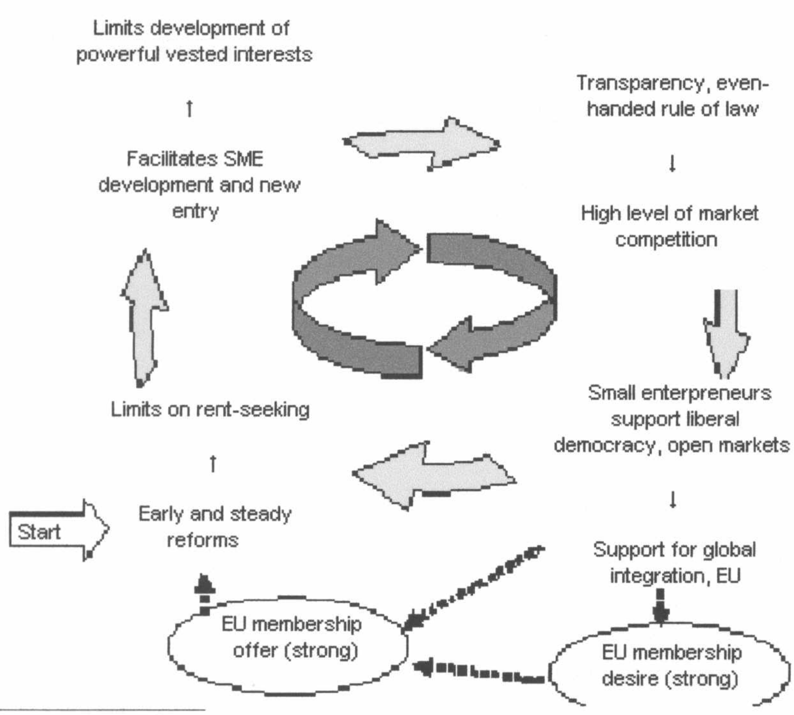
Figure 3.2

Vicious and Virtuous circles of reforms [242]

Vicious circle of delayed reform and oligarchic development



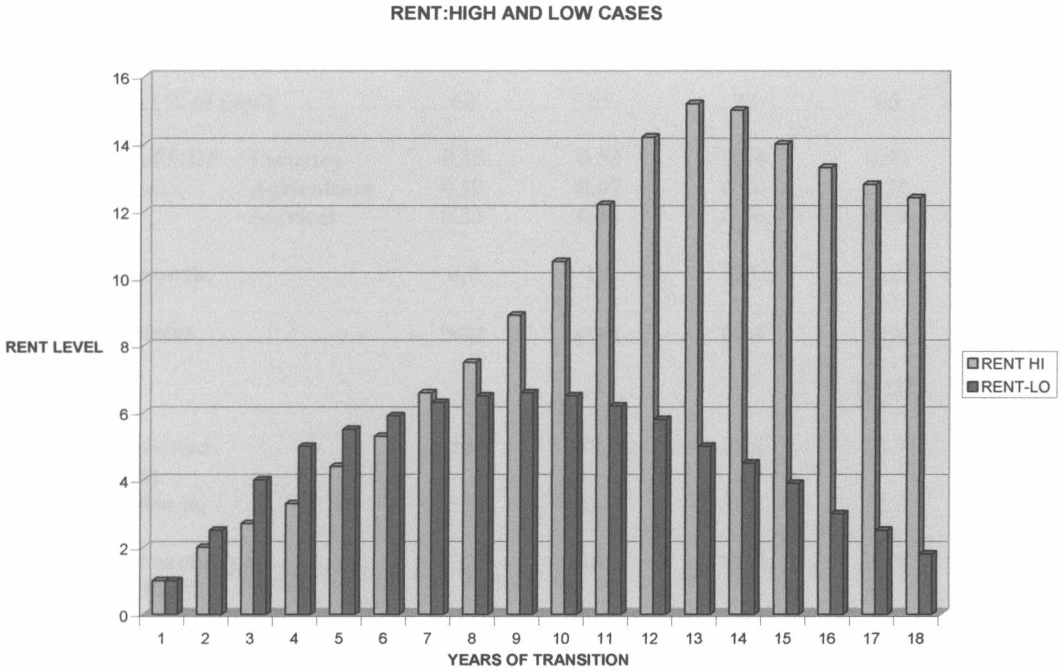
Virtuous circle of timely reform and development of competitive market and rule of law



[242] Havrylyshyn, O. (2006) pp. 138-139

Figure 3.3

Rent-seeking types: High and Low [243]



Low Case: rapid reforms close opportunities for rent-seeking

High Case: delayed reforms allow large rents, oligarch development

[243] Havrylyshyn, O. (2006) pp. 184

Table 3.1

Initial Level of Development, Resources and Growth, Economic Distortions and Institutional Characteristics [244]

Country		Croatia	Czech Rep.	Estonia	Belarus	Kazakhstan	Russian Fed.
Per cap GNP at PPP US$ (1989)		6171	8600	8900	7010	5130	7720
Urbanization (% of pop.)		62	65	72	66	57	74
Distribution of GDP 1990 cur prices	Industry	0.35	0.58	0.44	0.49	0.34	0.48
	Agriculture	0.10	0.07	0.20	0.22	0.29	0.15
	Services	0.55	0.35	0.36	0.29	0.37	0.37
Average % growth, 1985-89		0.2	1.6	2.7	5.2	4.3	3.2
Natural resources		poor	poor	poor	poor	rich	rich
Location		1	1	1	0 (1)*	0	1
Repressed Inflation 1987-1990 (%)		12	-7.1	25.7	25.7	25.7	25.7
Trade dependence, 1990 (%)		6.0	6.0	30.2	41.0	20.8	11.1
Black market exchange premium, 1990 (%)		27	185	1828	1828	1828	1828
State		1	1	0	0	0	1
Market memory / Years under central planning		46	42	51	72	71	74
Outcome of the first elections		Coalition	Non-communist	Non-communist	Coalition**	Renamed Communist	Renamed Communist
Initial Conditions Index* **		**2.5**	**3.5**	**-0.4**	**-1.1**	**-2.5**	**-1.1**

* - The indicator in brackets is the arbitrary estimation by the author;
** - Coalition until 1994, when Lukashenko came to power in Belarus;
*** - Initial Conditions Index is a weighted average of indicators for level of development, trade with CMEA, macroeconomic disequilibria, distance to EU, natural resource endowments, market memory and state capacity

[244] De Melo, M., C. Denizer, A. Gelb, S. Tenev (1997) , pp. 53-55, 84 // Havrylyshyn, O. (2006), pp. 169

Table 3.2

The Soviet Growth Rates, 1922-1985: alternative estimates (annual rate of change of Net Material Product *, in percent)[245]

Years	Official figures	Western estimates	Alternative estimates
1922-1940	15.3	5 to 6	8.5
1941-1950	4.7	No reliable estimate	- 0.6
1951-1960	10.3	6.5 to 7.5	9.3
1961-1970	7.0	5 to 6	4.2
1971-1980	4.9	2.5 to 3	2.1
1981-1985	3.6	2.0	0.6

* *Net material product* (or national income): this is the main aggregate in the Soviet national accounting system. It is a sum of values added, once the values of the inputs used in the production process have been deducted from the overall value of the production;

* It differs from the GDP in three ways:

  - It is net of the value of depreciation of the fixed assets;

  - It is material in the Marxist sense: the only items considered as material are the visible goods, and services do not add to the national income ecept when they are attached to the supply of goods. For instance, freight transport generates a value added which is included in the national income, but not passenger transport. Such a distinction among productive and non-productive services has always been very difficult to apply. In addition it does not take into account a large number of services which are included in the Western definition of GDP and GNP, such as education, health, administration, financial services, etc.;

  - Contrary to Western practice, it includes indirect taxes, as the latter are considered as a share of the net income accruing to the state, as distinct from the taxes paid out of the enterprise income. It might be called an aggregate at 'market prices', and not at 'factor cost'.

[245] Lavigne, M. (1999) pp. 45

Table 3.3

Progress with Institutional Reform [246]

	Initial Conditions Index[1]	Liberalization Index[2]		Inst. Quality[3]	EBRD Transition Indicators[4]	
Country\ Group		1989	1997	1997-98	1995	1999
EU accession countries (except Baltics)		0.16				
Bulgaria	2.1	0.13	0.79	0.1	2.5	2.9
Czech Republic	3.5	0.00	0.93	6.8	3.5	3.4
Hungary	3.3	0.34	0.93	8.7	3.5	3.7
Poland	1.9	0.24	0.89	7.0	3.3	3.5
Romania	1.7	0.00	0.75	-0.8	2.5	2.8
Slovak Republic	2.9	0.00	0.86	2.8	3.3	3.3
Slovenia	3.2	0.41	0.89	8.5	3.2	3.3
Baltics		0.05				
Estonia	-0.4	0.07	0.93	6.1	3.2	3.5
Latvia	-0.2	0.04	0.89	2.6	2.8	3.1
Lithuania	0.0	0.04	0.89	2.6	2.9	3.1
Other SE Europe		0.27				
Albania	2.1	0.00	0.78	-7.1	2.4	2.5
Bosnia & Herzegovina	-			-9.9	-	1.8
Croatia	2.5	0.41	0.85	0.3	2.8	3.0
FYR Macedonia	2.5	0.41	0.82	-3.3	2.5	2.8
C.I.S.		0.04				
Armenia	-1.1	0.04	0.72	-4.4	2.1	2.7
Azerbaijan	-3.2	0.04	0.62	-7.8	1.6	2.2
Belarus	-1.1	0.04	0.51	-7.6	2.1	1.5
Georgia	-2.2	0.04	0.72	-6.1	2.0	2.5
Kazakhstan	-2.5	0.04	0.86	-5.3	2.1	2.7
Kyrgyz Republic	-2.3	0.04	0.75	-4.2	2.9	2.8
Moldova	-1.1	0.04	0.75	-2.0	2.6	2.8
Russia	-1.1	0.04	0.83	-5.4	2.6	2.5
Tajikistan	-2.9	0.04	0.45	-15.0	1.6	2.0
Turkmenistan	-3.4	0.04	0.36	-11.5	1.1	1.4
Ukraine	-1.4	0.04	0.65	-5.8	2.2	2.4
Uzbekistan	-2.8	0.04	0.57	-10.4	2.4	2.1

Sources: *World Economic Outlook - October 2000: Focus on Transition Economies*, Washington, DC: IMF; *EBRD Transition Report*, London: EBRD, various years.

1. Initial Conditions Index - a weighted average of indicators for level of development, trade with CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory (measured by number of years of communist rule), state capacity.
2. Liberalization Index - a weighted average of three components: domestic market liberalization (weight 0.3), foreign trade liberalization (weight 0.3), enterprise privatization and banking reform (weight 0.4). Each component, and the average reported in the table, is scored in the range [0, 1].
3. Institutional Quality - index based on five components, namely extent of democracy, government effectiveness, extent of regulation, rule of law, and extent of graft/corruption. Each indicator is scored in the range -25 to +25 and so the average lies in the same range. For developed market economies the average score is 12.6.
4. Transition Indicators - based on a simple average of eight indicators each scored in the range 1 (no market reforms) through to 4 (conditions as in a developed market economy) or 4* (exceptionally strong development of market-based institutions). Scores with an asterisk are treated as adding one-third of a point to the aggregate.

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246 Hare, P. G. (2001) pp. 14

Table 3.4

Progress in structural transformation: the ERBD indicators (as of August 1997)[247]

	Priv/GDP (%)	*Lspriv*	*Sspriv*	*Enter restr.*	*Price lib.*	*Forex lib.*	*Comp. pol.*	*Bank Reform*	*Capital markets*
CzR	75	4	4+	3	3	4+	3	3	3
Est	70	4	4+	3	3	4	3	3+	3
Rus	70	3+	4	2	3	4	2+	2+	3
Kaz	55	3	3+	2	3	4	2	2+	2
Bel	20	1	2	1	3	1	2	1	2

Countries: CzR = Czech Republic, Est = Estonia, Rus = Russia, Kaz = Kazakhstan, Bel = Belarus

Priv/GDP – officially declared share of private sector in the creation of GDP

Lspriv – Large-scale privatization
4 Standards typical of advanced industrial economies, though the state of corporate governance may be unclear; 70 to 75 per cent of state assets privatized;
3+ More than 50 per cent of state assets privatized; still substantial insider ownership, though corporate improves;
3 More than 25 per cent of state assets privatized; substantial insider ownership, corporate governance improves little;
1 Little private ownership

Sspriv – Small-scale privatization
4+ Standards typical of advanced industrial economies; no state ownership of small-scale enterprises; effective tradability of land;
4 Complete privatization of small companies with tradable ownership rights;
3+ Nearly comprehensive program of small privatization implemented;
2 Substantial share privatized

Enter. restr. – Enterprise restructuring
3 Significant and sustained actions to harden budget constraints and to enforce bankruptcy legislation;
2 Moderately tight credit, weak enforcement of bankruptcy legislation; de-monopolization is slow;
1 Soft budget constraint (lax tax and credit policies); few efforts to promote corporate governance

Price lib. – Price liberalization
3 Substantial progress on price liberalization; energy prices, utilities not completely freed

Forex lib. – Foreign exchange liberalization
4+ Completed, with only some restrictions for capital movements;
4 Quasi convertibility of the domestic currency for current operations;
1 Widespread export/import and foreign exchange controls

Comp. pol. – Competition policy
3 Some efforts to promote a competitive environment; reduction of entry restrictions; difficulties in breaking up of large monopolies;
2 Competition policies and institutions beginning to be set up

Bank Reform – Banking system reforms
3 Fully-established two-tier system; framework for prudential regulation; significant presence of private or foreign banks though the banking sector remains state-owned in its majority; beginning of a lending policy though banks remain risk-adverse and lack experience in assessing the solvency of the enterprises, thus restraining credit and contributing to generate inter-enterprise arrears;
2 Liberalization of interest rates and credit allocation; limited use of directed credit of interest rate ceilings;
1 Two-tier system; no further reform

Capital markets
3 Creation of investment vehicles (investment funds, insurance, pension funds); opening of stock exchanges; issuance of securities by private enterprises and by the government;
2 Legislation for the setting up of stock exchanges; some trading in government bonds

[247] Lavigne, M. (1999) pp. 200-202

Table 3.5

Methods of Privatization of Medium-Sized and Large Enterprises [248]

	Sale to Outside Owners	Voucher Privatization (Equal Access)	Voucher Privatization (Significant Concessions to Insiders)	Management-Employee Buyouts
Czech Republic	Secondary	**Primary**	..	..
Estonia	**Primary**	..	..	Secondary
Croatia	..	..	..	**Primary**
Belarus	..	..	..	..
Kazakhstan	Secondary	**Primary**	..	..
Russia	Secondary	..	**Primary**	Tertiary

[248] Alsund, A. (2002) pp. 270

Table 3.6
Areas of Remaining Major Reform Backlog [249]

Countries	Large-Scale Privatization	Small-Scale Privatization	Governance & Enterprise Restructuring	Price Liberalization	Trade & Foreign Exchange System	Competition Policy	Banking Reform & Interest Rate Liberalization	Securities Markets & Nonbank Financial Institutions	Commercial Law	Financial Regulation Law	*Memorandum* Macrostabilization Not Achieved: Inflation[2]	*Memorandum* Macrostabilization Not Achieved: Budget deficit[3]
EU accession countries (excluding Baltics)												
Bulgaria			■			■		■				
Czech Republic												
Hungary												
Poland												
Romania			■			■		■				
Slovak Republic								■				
Slovenia						■						
Baltic countries												
Estonia												
Latvia								■				
Lithuania						■						
Other southeastern European countries												
Albania	■		■			■	■	■	■	■		■
Bosnia & Herzegovina	■	■	■			■	■	■	■	■		
Croatia						■		■				■
Macedonia, FYR			■			■		■		■		
Commonwealth of Independent States[4]												
Armenia			■			■	■	■				
Azerbaijan	■		■			■	■	■		■		
Belarus	■	■	■	■	■	■	■	■	■	■	■	
Georgia			■			■	■	■	■	■		
Kazakhstan			■			■	■	■				
Kyrgyz Republic			■			■	■	■		■		■
Moldova			■			■	■	■				
Mongolia	■		■			■	■	■				■
Russian Federation			■		■	■	■	■				
Tajikistan	■		■			■	■	■				
Turkmenistan	■	■	■	■	■	■	■	■			■	
Ukraine	■		■			■	■	■	■	■		
Uzbekistan			■	■	■	■	■	■		■		

Source: European Bank for Reconstruction and Development, *Transition Report 1999*; Asian countries not members of the CIS were evaluated by IMF country specialists.
[1]EBRD indicators whose value is less than 2.5 in 1999.
[2]Projected inflation in 2000 exceeds 30 percent.
[3]Projected budget deficit in 2000 exceeds 5 percent of GDP.
[4]Data include Mongolia.

[249] IMF: "World Economic Outlook" (2000) pp. 124-125